

Center for Strategic Studies and Reforms

Moldova in transition

ECONOMIC SURVEY

No. 4, 1999

Chişinău, December '99

CENTRUL
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CENTER
*for Strategic Studies
and Reforms*

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PREFACE

Ten years ago, soon after the fall of the Berlin Wall, significant political and economic changes began in Central and Eastern Europe. Now, more than 20 European countries, which in the late 80's still belonged to the "world socialist system", have a decade of experience with transition to the democratic political system and a market economy.

Can we mention here some concrete results of this experiment? Too little time has passed. In some countries in transition evident progress has been made. But there are only few countries like these –Poland, the Czech Republic, Hungary, Slovenia, Estonia. Most countries in transition have stagnated for most of the decade; their output and living standards continue to decline, breeding chronic political instability.

Unfortunately Moldova is also one of the stagnant countries. We admit this as citizens of Moldova. This follows clearly from the evaluations of various international institutions, in whose ratings Moldova ranks among outsiders.

Today, after a ten-year experience, the following questions are justified: what is the balance between success and failure? How correct proved to be the rapid liberalization of economy? How macroeconomic, structural, and social policies were coordinated? What were the trends of the main elements of welfare in this state? What political factors should be taken into account in determining the pace and the sequence of reforms? And finally, what needs to be done?

The contents of the present edition of "Moldova in Transition" spells out the country's profile of the 90's transitional decade, including political, human development, and economic factors. Special attention is given to the 1999 year - the year of contrasts and stresses in the economic and social development, the year of three (!) governments, the year of soaring the political uncertainty in the country.

The present issue of the survey has been prepared by the Center for Strategic Studies and Reforms within the framework of the UNDP/WB Project "Strategy for Development". Official data (from the Ministry of Economy and Reforms, Ministry of Finance, National Bank of Moldova, Ministry of Labor, Family and Social Protection, and the Department of Statistical Analysis and Sociology) were used in our analysis. At the same time, the opinions and conclusions presented in this study are entirely those of the authors and do not necessarily express the viewpoint of the state structures and the organizations which finance the research. Cooperation of the Center for Social and Economic Research Foundation (CASE – Warsaw, Poland) is also acknowledged.

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We invite you to collaboration.

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1. TRANSITION: A LONG WAY TO WELL-BEING

It has now been ten years since the time when the Republic of Moldova, amongst other Central and East European (CEE) nations and countries of the former Soviet Union (FSU), adopted the course towards transformation of its political and economic systems. Then - a decade ago – the principal goal of reform efforts was to ensure transition from an authoritarian political system and centrally-planned economy to a democratic state with a market economy and civil society.

So far, these efforts have produced only partial and mixed success. Positive results are few and most of these are in the area of economic and political freedoms – openness of the country, democratization of public life (multi-party parliamentary and local elections, freedom of religion, mass media, NGOs, etc.). Social implications of transition, on the other hand, have been dramatic and essentially signaled a transition to poverty. Economies of most of the countries in the region find themselves in deep recession, with only a few that registered growth of output.

In 1998, only Poland, Slovenia and Slovakia had higher output levels relative to the year 1989 – or the last pre-transition year. On average, by 1998 CEE countries have recovered at least 90% of their measured output relative to the pre-transition year of 1989, while the corresponding figures for FSU countries are about 60% to 70% (*See Table 1.1*).

Social and economic performance amongst the transition countries of CEE and FSU has varied substantially. But now, ten years after, in all these countries including Moldova questions are raised on the matters concerning both the transition strategy and the political factors that determine the choice of economic policy.

As common sense goes, all reforms are designed for the better. In the beginning of the 90's, economic reforms in the region were aligned with the neo-liberal economic thought and included three main components: economic liberalization (including price liberalization and liberalization of trade and enterprise activity), privatization and macro-economic stabilization.

Albeit each with individual result depending on the country's background conditions (i.e. level of overall development, structure of the economy, national specifics of life, etc.), practically all countries in transition including Moldova have fulfilled these tasks by the mid-90's.

Yet, the miracle was not to occur. Despite the differences in methods of implementation of the reform strategy based on neo-liberal approach, they have not brought about significant improvements in the real sector of the economy and seriously affected the living standards in nearly all countries of the region.

Table 1.1. **Transition Economies: Output Performance, 1989 – 1998**

Country	Cumulative output decline (1989=100)	Year in which output was lowest	Cumulative output growth since lowest level	Year in which output was highest	Ratio of output in 1998 to output in 1989
Albania	39.9	1992	43.0	1989	0.96
Armenia	65.1	1993	29.7	1989	0.53
Azerbaijan	63.1	1995	17.8	1989	0.50
Belarus	36.9	1995	24.0	1989	0.81
Bulgaria	36.8	1997	4.0	1989	0.72
Croatia	37.7	1993	30.8	1989	0.82
Czech R.	15.4	1992	12.8	1989	0.97
Estonia	36.4	1994	25.7	1989	0.89
Georgia	74.6	1994	30.6	1989	0.48
Hungary	18.1	1993	16.3	1989	0.95
Kazakhstan	40.0	1998	0.0	1989	0.69
Kyrgyz R.	50.4	1995	20.1	1989	0.66
Latvia	52.8	1993	17.0	1989	0.64
Lithuania	40.8	1994	19.8	1990	0.71
Macedonia, FYR	46.6	1995	7.4	1989	0.57
Moldova	66.3	1998	0.0	1989	0.42
Poland	13.6	1991	42.6	1998	1.23
Romania	26.7	1992	3.4	1989	0.82
Russia	45.1	1998	0.0	1989	0.61
Slovak R.	24.7	1993	32.9	1998	1.00
Slovenia	20.4	1992	25.4	1989	1.00
Tajikistan	74.0	1996	7.1	1989	0.45
Turkmenistan	59.5	1997	4.5	1989	0.45
Ukraine	63.8	1997	0.8	1989	0.42
Uzbekistan	14.4	1995	7.0	1990	0.88
All Transition Countries	41.8	1993	17.0	1989	0.7
All CEE	28.0	1992	21.9	1989	0.9
Baltics	21.6	1994	20.8	1989	0.7
Other FSU countries	37.5	1995	11.8	1989	0.6

Sources: IMF. Database incorporating national statistics, World Economic Outlook, 1999.

It should be stated that during all these years social aspects of reforms have been constantly neglected as a secondary priority. Efforts in the social sector have customarily been of a fragmentary nature. According to World Bank estimates, the number of people in CEE and FSU countries living on less than 4 dollars per day rose from 14 million in 1989 to 147 million in mid-90s. By some estimates, in Moldova, about 66% of the population live below the poverty line, while 20% of the “newly rich” enjoy 50.3% of national income and the 20% of the “newly poor” are left with only 3.4% (1998).

As in the countries of Latin America and Africa, rapidly growing foreign debt has become another common problem for the CEE and FSU countries. By the end of 1999, Moldova's

external debt is standing at about US\$ 1 billion – or over 100% of GDP - and the possibility for default may become reality.

All transition countries employed identical reform strategies recommended from abroad. Should it not lead to the conclusion that while sharing in the benefits of transition of some countries, Western nations should also take part of the responsibility for failures of the others?

In this respect, the remark made by Mr. James Wolfensohn, President of the World Bank, is well worth being noted: “It is that if you want to have stable growth, then it is important to deal with the social and poverty issues, because if you do not deal with the social and poverty issues and structural issues attendant to it, then you find that your growth is not stable. You have social and other eruption in society.”¹

Radical criticism of the neo-liberal model and its social implications countries can be found in the UNDP’s 1999 Human Development Report for CCE and CIS countries: “Before the 1990s, countries of Central and Eastern Europe and CIS were notable for providing their population with a high degree of basic security... The transition period has drastically altered this situation.”²

More criticism is also voiced within the Republic of Moldova of the social consequences of transition.³ Such criticism is well supported by factual evidence. In the past decade, there has been a considerable worsening of all indicators of living conditions. In 1998, the Human Development Index (HDI) for the Republic of Moldova, according to the estimations of the Department of Statistical Analysis and Sociology, was equal to 0.697 (in 1993 it was 0.718). The main components of HDI for Moldova today are: global domestic product per capita at purchasing power parity – US\$ 2,042; life expectancy at birth – 67.0 years; literacy for adult population – 94.6%.

The Republic of Moldova, in spite of the worsening of HDI in the last years, still remains within the group of states with a “medium level of human development”. Among 174 countries included in the UN rating list (Human Development Report 1999), Moldova is situated at the 104th place, having as neighbors Albania, Tunisia, Indonesia, El Salvador and other developing countries.

Transition has brought a great deal of disappointment. In Moldova, as in other countries of the region, social costs of market transformation turned out to be significantly greater than originally assumed by reform designers. This has contributed but to the narrowing of the social base of support for reforms. It appears that yet another attempt (repeated in the same part of the world!) to deliver to the people a ‘brighter future’ through forceful measures proved ineffective.

How does one explain what happened? There exist various explanations. One admits that the theory is viable, but implementation is often weak or erroneous. Another explanation points out to differences in nations’ backgrounds, people’s mentality, etc.

¹ IMF Institute Conference on Second Generation Reforms, Washington, D.C., 1999

² Human Development Report for Central and Eastern Europe and the CIS, UNDP, 1999

³ “Republic of Moldova 1999”, National Human Development Report, UNDP Moldova, 1999; P. Ronnas, N. Orlova, “Twice Hit – Badly Wounded: The Devastating Cost of an Inadequate Transformation in Moldova”, SIDA 1999; “Moldova: Strategies for Poverty Reduction”, World Bank 1999; N. Orlova, “Moldova: Transition to Poverty”, MA thesis, The Hague Institute of Social Studies, 1998

However, one of the most plausible explanations of failures of the transition period lies in the weakening of the role of the state, lack of consistence and coordination in between different political, economic and legal institutions (or the so-called “institutional weakness”). No matter how paradoxical it may seem, both adepts and critics of transition reforms support this explanation.

The state and its institutions stepped forward as initiators of reforms. However, most of transition countries, including Moldova, were in the beginning under the illusion that it was possible to effectively combine, during the transition period, socialist paternalism (statism) with market self-regulation.

The weakness of the state and the low level of political consent in Moldovan society did not allow permit the required regulatory role of the state in implementing reforms. In particular, state systems, undergoing a deep crisis, proved to incapable of initiating timely structural reforms, of collecting taxes as needed and of ensuring budgetary support of the poor strata of population.

Since crises usually aggravate inequality, the Government should have stimulated private sector development to function as a shock absorber for unemployment, should have reorganized the system of social assistance and should have undertaken measures in order to protect the poorest from economic shocks. Thus far this has not happened.

Disappointment was generated also by the property reform, based on rapid mass-privatization by vouchers, oriented towards granting everybody “equal starting opportunities.” In reality, it did little more than turn poor-quality assets over to a large number of poor owners and channel high-quality assets to the “agile and connected.”

The populist privatization method and slow pace of reforms in the agro-industrial sector (a key sector of the national economy!) did not facilitate the turnover to efficiently working owners or good corporate governance of enterprises, which in its turn had an extremely negative influence on the real sector dynamics, its exporting possibilities and the level of employment.

On the macroeconomic front, the efforts to reduce inflation and the state budget deficit were not so sustainable. Much of the success attained by Moldova by the mid-90s in the area of macroeconomic stability was subsequently, especially after the financial crisis in Russia in 1998, reversed.

Non-compliance with the laws and decisions of courts has also led to the state's inability to rein in the underground economy, which has greatly expanded (not less than 50% of GDP), leading to a vicious circle of corruption, hidden firm activity, reduced public revenues, and a dramatic widening of the population's income inequality.

Low quality of governance reflected in spread of corruption, the incidence of which in Moldova puts the country amongst the 25 of the most corrupt countries in the world.⁴ Corruption and poverty are the two sides of the same coin. Corruption not only causes severe stress in the everyday lives of the country's people but also stifles private economic initiative and the development of entrepreneurship as a driving force in a market economy and a means of “self rescue” during periods of hardship.

⁴ 1999 Transparency International Corruption Index, “Transition”, October 1999, p.2

1. TRANSITION: A LONG WAY TO WELL-BEING

The low social efficiency of the reforms, the sharp income discrepancy and drawbacks in distributing the fruits of economic development (“newly rich” against “newly poor”) have led to deepening and to a critical shortage of state funds for the support of public services, particularly for primary health care and basic education.

Table 1.2.

MAIN MACROECONOMIC INDICATORS

	1994	1995	1996	1997	1998	1999f
Real GDP growth rate	-30.9%	-1.4%	-7.8%	1.6%	-8.6%	-2.5%
Nominal GDP (excl. Transnistria), lei million	4737	6480	7658	8917	8804	11926
Nominal GDP, USD million	1164	1443	1665	1933	1630	1131
GDP per capita, USD	322	400	463	538	454	315
Export (fob), USD million	618	739	823	890	644	470
Export, yr/yr	156.5%	119.6%	111.4%	108.1%	72.4%	73.0%
Import (fob), USD million	672	794	1075	1235	1043	540
Import, yr/yr	126.8%	118.2%	135.4%	114.9%	84.5%	51.8%
Trade balance, USD million	-54.0	-55	-252	-345	-399.0	-70
Current account, USD million	-92	-115	-188	-269	-333	11
as % of GDP	-7.9%	-8.0%	-11.3%	-13.9%	-20.4%	1.0%
Foreign direct investments, USD million	18	73	23	71	86	80
as % of GDP	1.5%	5.1%	1.4%	3.7%	5.3%	7.1%
Stock of foreign debt, USD million	627	765	921	1008	954	841
as % of GDP	53.8%	53.0%	55.3%	52.1%	58.5%	74.4%
NBM gross forex reserves, USD million	180	257	314	366	144	202
NBM reserves in months of imports of GFS	2.87	3.04	3.00	3.07	1.40	3.46
Internal debt, million lei	270	477	737	940	1500	1700
Budget balance as % of GDP	-5.9%	-6.7%	-7.6%	-7.8%	-3.4%	-5.2%
Annual inflation rate (end period)	104.6%	23.8%	15.1%	11.2%	18.3%	40.4%
End-year exchange rate, lei/1USD	4.27	4.50	4.65	4.66	8.32	11.69
Average exchange rate, lei/1USD	4.07	4.5	4.6	4.6	5.4	10.5
Nominal end-year appreciation(+)/depreciation(-), MDL/USD	-17.3%	-5.4%	-3.4%	-0.2%	-78.6%	-40.5%
Nominal end-year appreciation(+)/depreciation(-), USD/MDL	-14.8%	-5.1%	-3.2%	-0.2%	-44.0%	-28.8%
Real end-year appreciation(+)/depreciation(-)	+74.4%	+17.5%	+11.4%	+10.9%	-33.8%	-0.1%

The degree of success of the implementation of the neo-liberal plan in Moldova can be assessed by way of analyzing the dynamic of main macro-economic indicators (*See Table 1.2*). More detailed assessment of trends and effectiveness of transition in different sectors of the national economy is given in subsequent chapters of the survey - quality of governance, finance sector, structural reforms, private sector development, investment climate, social dimensions, regional aspects, effects of political factors, etc.

Looking back on the past decade, at least five conclusions are important for solution modeling for the future.

First: It is necessary to ensure *a society-wide consensus* with respect to the content of reform and inter-relationships between its different components. Political stability and new economic order can only be sustainable if supported by the population.

Second: The country requires *a strong and effective government* that is able to enforce law and to maintain institutions, norms and practices essential for genuine market economy and sustainable human development. Weakness of government structures increases non-compliance with laws and official regulations, and in particular tax evasion. Weak government is more likely to be corrupt.

Third: To break the vicious circle of recession is possible only through increased attention to the *real sector of the economy*. This essentially requires creation of an effective system of incentives benefiting both businesses and the state; improvement of corporate management of newly privatized enterprises; effective protection of the rights of investors and ensuring

transparency of commercial tenders; support for the small and medium enterprise sector which serves as a basis for the development of the middle class – the main social force behind reforms. Concomitant with these efforts should be the measures aimed at eliminating the gap between the banking and manufacturing sectors of the economy, through reducing the *influence of certain lobbies and special interest groups* on the decisions concerning import/export transactions, energy sector, privatization, and demands for higher budgetary outlays.

Fourth: In the course of transition from centrally-planned to market economy, the state has retained its *social responsibilities*. Management methods in the area of social security, however, need to be changed. Of primary importance for Moldova are now the issues of poverty eradication, reform of social insurance system, health care reform, education and labor market formation. The principal difficulty associated with the social sector reform lies in the need for the new arrangements to be both socially just and economically balanced.

Fifth: Success of transition is directly related to the extent to which its *political and economic components* are effectively combined. The experience of Moldova, both positive and negative, including the reality of 1999, demonstrates explicitly the connection between the reforms progress and political stability. Political risks and disordered policies of the state pose a serious obstacle on the way of reforms.

Better informed citizenry will more likely take an active part in political decision-making. Social unrest, mass strikes and street protests constitute an extreme form of expression of popular will. In this light, it is vital to promote in all possible ways *the transparency of government* through an effective system of public information dissemination. Equally important is to promote all forms of education, including retraining and enhancing professional qualifications, legal, medical and ecological education to supply the population with knowledge and skills necessary to guarantee effective social transformations. Thus, conditions will be created for the emergence of a stronger *civil society* capable of solving key political, economic and social problems.

All this is ever more important, considering that at the end of 1999, the country finds itself in a critical situation marked by lack of confidence in power structures exhibited by the populace and high volatility and unpredictability of future developments.

The lessons of the transitional decade have freed the country from illusions. Both for the government and for the population it has become clear that the way towards a socially oriented market economy and well-being – both for the population and for the state – will not be short. The question has emerged about the need for a new policy that would better fit the interests of human security now and sustainable development of the Republic of Moldova in the near future.

2. MACROECONOMIC TRENDS: DEFERRED STABILIZATION

As it was comprehensively described in the CISR Economic Survey 2, Moldova, like other post-communist economies, joined the transition process having a high rate of inflation and massively decreasing production. After the surge in administered prices in early 1992, sharp price increases followed, leading to hyperinflation (in 1992 – 1280%). In such environment, the so needed budget deficit reduction, along with reforms in real sector, have not been started. Moreover, the deficit was financed by extensive money printing, as well as preferential centralized loans, which ultimately generated a non-productive consumption, since the loans were frequently absorbed by inefficient state enterprises that should have been either restructured or bankrupted.

The currency stabilization environment had to be built up from scratch since in 1991, when Moldova became an independent state, the foreign exchange and gold reserves were zero, and there was neither a foreign exchange market, nor even a central bank of the state.

Introduction of the National Currency

On November 29, 1993 Moldova introduced its national currency, the Moldovan leu. A floating currency regime was adopted, or more exactly – a managed floating regime, since the country had no gold or significant hard currency reserves and a fixed exchange rate or a pegged regime could at a larger extent expose the economy to shocks.

The program of financial stabilization and structural reforms, adopted along with the introduction of the leu, was supported by the IMF through stand-by arrangements (in fact if no IMF financial support followed, than it would have been impossible for Moldova to introduce its national currency, given the existing circumstances). The IMF program, which covered the period through March 1995, was designed to secure a stable leu through the adoption of tight financial policies. The program also sought to advance economic restructuring through the liberalization of domestic and international trade and payments systems and the introduction of key structural reforms. In addition to IMF support, the program received support from other bilateral and multilateral donors, including the World Bank.

Banking Environment

In June 1991 the Parliament of Moldova approved the banking laws, which established the basis of the actual 2-tier banking system of the country. The NBM being the sole money issuance authority of the state - drawing up and implementing monetary, credit, and foreign exchange policies, setting the regulatory framework for commercial banks and supervising their activity. At the end of 1991 fifteen commercial banks were operating in Moldova, and their number reached 22 by the end of 1993. Since then this figure did not vary too much. As of November 1999 out of the existing 22 commercial banks, 5 originated from the reorganization of the former state specialized banks, and 17 are new banks, including branches of some foreign banks. Aimed at regulating banking activity and insurance of banks' stable financial standing, as well as for protecting banking creditors and depositors, starting with 1992 the NBM put in place prudential regulations for all banks which set standards for the Moldovan banking system compatible with international standards (the Basle provisions).

The situation in banking system of Moldova has been stable during 1993-1997 and did not suffer from any major shocks similar to those that occurred in Romania, Russia, Latvia or other European countries in transition. However, from the financial prospective, banking system cannot be considered a strong one because of lack of funds, and this imposes a firm prudential accent to banks' behavior in the market, as well a need in competence and responsibility in taking decisions. Otherwise banks risk to go bankrupt, as it already happened with several

commercial banks of Moldova. As in most cases of bankruptcy that happened in industrial countries, in transition countries, including Moldova, the main cause of this phenomenon is banks' mismanagement, as well as fraud and abuse in personal interest, that generated an unjustified concentration of risks in specific branches or economic entities, at the same time banks' management allowing crediting of insolvent clients.

Credit Allocation

Before 1993 the central bank was providing directed and centralized loans in the amounts requested by the Government. Since August 1993, when the first refinancing auction took place and till mid-June 1998, the main type of credit allocation was credit auctions held at the NBM. In 1994 NBM's preferential credits have been phased out. However, the Government itself continued to provide state guarantees for commercial banks' loans to some economic agents. Starting with the issuance of state T-Bills in 1995, NBM's direct credits for financing state budget were granted by the NBM against state's T-Bills. However, so far servicing of these loans by the Government has been continuously rescheduled.

Interest Rates

The annual refinancing rate established at credit auctions increased significantly through late 1993 reaching a peak of 377% in February 1994 (Figure 2.8). Then, as inflation declined, the auction rate began to drop. The decrease of inflation rate has had a positive effect on NBM refinancing rate that became positive in real terms starting with January 1994. Real refinancing rate rose significantly in 1994 and peaked by mid-1994 (which brought the first symptoms of suffocating economy and urged NBM to start a decrease in interest rates).

By the end of 1997 the refinancing rate reached its lowest level of 16%. On the other hand, average interest rates in the banking system have declined continuously during 1997 (Figure 2.22). The movement in interest rates shows that there has been a widening of spreads between rates on deposits and loans, indicating lack of a real competition between banks, as well as the fact that some banks tried to increase their profits granting risky loans.

Real interest rates in the banking system always remained quite high as high borrowing requirements of the Government combined with low supply of domestic savings led to the high interest equilibrating the financial market. At the same time, international savings could be attracted only at the interest rate inclusive of significant risk premium (due to the high country risk rating of Moldova) so that domestic real interest rate remained high above the world level. High interest rates on T-bills caused an increase in the opportunity cost of lending, thus crowding out credit investments to the private sector and leading to a situation when a portfolio of major part of banks consisted mainly of profitable and relatively risk-free government securities. On the other hand, high systemic risk, driven by the weakness of court and legal environment (for instance lack of legal basis for land collateral and mortgage loans) further reduced the incentives for search for profitable lending opportunities. As a result, the lack of serious competition between banks, as well as their undercapitalization, meant that private lenders had to bear the excessive cost of credits, at the same time not being allowed to borrow from foreign banks, due to the capital account restriction imposed by the central bank.

Analyzing banks' crediting activity, it should be stressed out that there is a problem of availability and cost of credit, partly resulting from insufficient development and limited competition in the commercial banking sector, which continues to keep the real cost of credit at a quite high level. Generally speaking, the low share of long-term loans in banks' portfolio is a typical problem in case of transition economies. On the other hand, the main goal of banks is profit maximization, but at the same time the banks should be very cautious, especially in such an environment. Because of big risks (economic instability and imperfection of collateral mechanisms), commercial banks refuse to make long-term investments in national economy (that in fact could

2. MACROECONOMIC TRENDS: DEFERRED STABILIZATION

ensure the economic growth). And they obviously cannot provide long-term loans having a mainly short-term deposit base.

At the same time, one of the main causes of insufficient crediting of production sector is not just the acute lack of financial resources, but lack of efficient investment projects and small number of solvent economic entities, that could efficiently use the credits and reimburse them in due time.

State Securities

Starting with 1995, the budget deficit is covered mainly by issuance of state securities (Treasury bills and bonds) and not only by direct lending from the central bank. Thus, the needed budget funds are attracted from the financial market, avoiding additional money issuance by NBM.

The initially high interest rates decreased steadily (Figure 2.11), while inflation rate was brought down close to 10%. Between 1995 and 1997 the NBM strict monetary policy and the commitment to stabilize the exchange rate induced significant credibility to domestic and foreign investors. The rates on T-bills fell with the increasing maturity of the debt: 182 days T-bills were introduced in 1996 and 273 days treasury securities in 1997. Moreover, the hump shaped yield curve suggests that investors anticipated a slow depreciation (successful dis-inflation) of the currency in long run. The volume of T-bills sales doubled both in 1996 and 1997. The average market rates halved between 1995 and 1997, which reduced the dependence of the budget on the direct credit from the Central Bank. Still, the rates were often high enough (also comparing with deposit rates) to allow commercial banks to use available funds for buying T-Bills and getting easy and guaranteed profits instead of crediting the economy.

First Anchor - Control Over Monetary Supply

With the introduction of the Moldovan leu, a tight monetary policy was implemented, which proved to be one of the most successful (along with the one of the Baltic States) in the FSU. The following monetary instruments were used: reserve requirements, refinancing auctions, interventions in the foreign exchange market, and open market operations with securities. The last one is certainly most recommended, but it started to be utilized only after August 1997, when the securities market was sufficiently developed.

The rate of inflation decreased sharply in 1994. While in 1993 annual inflation was higher than 2000%, then at the end of in 1994 it came down to 105%, in 1995 it was already 23.8%, in 1996 – 15.1%, and in 1997 – 11.2% (Figure 2.7).

However, even having an adequate volume of broad money, or an adequate monetary policy of the central bank, this does not implicitly mean the total control over the inflation, since the inflation rate could go up influenced by indirect, non-monetary factors, such as administrative increases in prices and tariffs (housing services, transport, energy etc.), or some seasonal tendencies.

Looking at the structure of broad money (Figure 2.12), one can notice that the volume of deposits in the banking system was increasing continuously (the biggest share being of those in lei), clearly showing the increase in confidence in the leu (supported by the stable exchange rate and the rapid decline in inflation) and the increasing reliance on foreign currency deposits to finance current transactions rather than as a store of value.

Table 2.1. Monetary aggregates

End-year:	Inflation	M0 growth	M3 growth	RM growth
1994	104.5%	191.9%	87.6%	136.1%
1995	23.8%	84.9%	65.1%	41.8%
1996	15.1%	14.5%	12.8%	8.4%
1997	11.2%	33.0%	37.0%	35.9%
1998	18.3%	-12.0%	-8.7%	-5.5%

During 1996 and 1997 the confidence of the population in banking system has grown, and this is reflected by the continuous increase of households' deposits with commercial banks.

Second Anchor - Exchange Rate

During 1993 the coupon depreciated by 900%, while already in 1994 the Moldovan leu depreciated against the US dollar only by 14%. Further on, leu showed a remarkable stability, and the yearly nominal depreciation index (US\$/MDL) was: 5.1% in 1995, 3.2% in 1996, and 0.2% in 1997 (Figure 2.5). The stable exchange rate was used as a second anchor (apart from control over money supply) for keeping the inflation in place. However, over a medium and long-term period, only one anchor, i.e. monetary policy, should be sufficient.

Along with the reduction of inflation, the Moldovan leu started to appreciate in real terms against the Russian ruble, Ukrainian karbovanets, US dollar and other currencies. Thus, the real exchange rate index indicated an appreciation of leu against US dollar by about 74% in 1994, by 17.5% in 1995, 11.4% in 1996, and 10.9% in 1997 (Figure 2.18).

This continuous appreciation of the leu, in the presence of huge and rising Balance of Payments disequilibria (current account deficit to GDP ratio was 14% in 1997), has generated many objections (especially in 1997) from the exporters' side, which claimed that an overvalued leu made Moldovan exported goods too expensive, thus deteriorating their competitiveness. At the same time, a devaluation of leu would cut the massive imports, especially of commodity goods. But, on the other hand, the devaluation would not solve the problem, since almost one third of imports were energy resources. Besides, depreciation would have caused problems to the Government in terms of external debt service, and also would cause the reduction of households' real incomes.

Analyzing the path of the exchange rate during 1994-1997, it may be seen that there were some common tendencies generated by seasonal fluctuations of the supply and demand for hard currency in the forex market. The seasonal character of Moldova's economy, which is strongly relying on the agriculture sector, explains them.

Foreign Exchange Regime

The NBM has been gradually implementing a policy of foreign exchange market liberalization. NBM's foreign exchange reserves at the end of 1993 stood at US\$77m. On January 17, 1994 NBM approved the new Regulation on Currency Control, which authorized buying of hard currency for current account operations. From November 15, 1994 the surrender requirement was cancelled, thus economic agents being able to freely dispose of their export earnings, kept with banks. This was a strong evidence of leu's stability.

The building up of reserves evolved further (Figure 2.17). Thus, at the end of 1994 gross reserves already reached US\$180m, 1995 - US\$256m, 1996 - US\$314m. At end-1997 gross reserves reached - US\$366m (covering 3.1 months of imports of goods and services), out of which US\$132m represented net reserves.

Rules of export-import of hard currency in Moldova have been simplified, while quite liberal regulations have been set regarding keeping hard currency on deposits with Moldovan banks. These actions led to a growing confidence in leu from population and economic entities. Consequently, the exchange rate of leu has stabilized, the volume of lei deposits with banks increased, while the "street" activities and black currency market phenomena have practically wiped out.

The above-mentioned measures and results obtained served as a good reason for the NBM to accept on June 30, 1995 the Article VIII, sections 2, 3, 4 of the IMF Articles of Agreement. This represented *de jure* the convertibility of Moldovan leu for current account operations, and for some capital account operations. As a result, any resident or non-resident individual or legal entity have been allowed to exchange with no limits lei into hard currencies

and *vice-versa*. Foreign investors were granted the right to freely repatriate capital to their country of origin. Residents, working abroad, can freely transfer their earnings to relatives in Moldova. However, individuals residents of Moldova are not allowed to transfer abroad the money from their hard currency accounts with local banks, with a few exceptions such as for medical care, studies and other.

Unsustainable Fiscal Policy

Moldovan fiscal policy in recent years was driven by inertia and pressure from groups of interest. The slow path of structural reforms and the general weakness of the state reflect this statement. Loose fiscal policy in turn reduced the determination in reforming the state structures. Arrears and netting-out operations led to the development of a non-payment culture. At macroeconomic level, expansionary fiscal policy led to high absorption in the economy that was not met by the supply side response due to the impeded restructuring process. It fuelled imports and the trade balance steadily deteriorated. At the same time, capital inflows necessary to finance the budget deficit, combined with domestic restrictive monetary policy, prevented the depreciation of the currency. The ultimate result of the policy mix was the rapid accumulation of external debt and expenditure arrears. The unsustainability of both internal and external position of the state led to the inevitable financial crisis.

It is well established that transition countries that implemented tight fiscal policy resumed the growth sooner and it was both more stable and higher in comparison to countries with large and unsustainable budget deficits and associated high levels of government spending. The reduction of state budget deficit is the most important condition for medium-term stabilization and growth of Moldovan economy. The fiscal policy could not sufficiently be disciplined by a restrictive monetary policy.

Macroeconomic developments in Moldova in last years exhibits striking contrast between consequent tight monetary policy and loose, arguably unsustainable fiscal policy. While inflation and monetary aggregates show an impressive dynamics, not yet achieved even by the most advanced transition economies, budget deficit share in GDP exhibited almost double-digit values.

Fiscal policy can be changed only with significant time lags and also it takes years until its full impact on economic development is observed. Monetary policy, on the other hand, can be adjusted more rapidly and the response of the economy is prompter. Namely, even under fiscal policy that is unsustainable in the longer run, the short-term monetary stabilization can be achieved. Effects of inflation and exchange rate pressures, combined with high interest rates will accumulate slowly, with the adverse influence not only on the price stabilization but also on the economic growth in the medium term horizon. Only programs that combined both fiscal and monetary tightening brought long lasting stabilization in Latin American countries. Programs that ignored the fiscal component yielded only temporary results at best. Non-inflationary sources of budget deficit financing cannot substitute for real fiscal adjustment. Although most of the countries that reduced significantly the budget deficit financing from money emission achieved short-lived price stability, the scale of fiscal adjustment was the factor that differentiated recent macroeconomic developments in CIS countries and other countries of Central and Eastern Europe.

In Moldova, internal imbalances have been persistently converted into external problems. The domination of demand over supply of goods has not produced inflation, as it was settled through imports. Similarly, the budget deficit was financed without monetization through foreign capital inflows. Financing twin deficits through external borrowing was relatively easy since Moldova started its independent economic life in 1992 without foreign debt.

Unsustainable fiscal policy put all the responsibility of maintaining stabilization on the monetary policy, which leads directly to the necessity for further monetary tightening. Monetary policy could not, however, compensate for the weakness of fiscal budget in a longer time period. Moreover, the fiscal policy in Moldova was constantly undermining the credibility of the stabilization, making required monetary policy still harsher. Possible results of such policy mix are listed below:

- i) High real interest rates held by the deficit borrowing requirements, with reduction of the capital available to the growth-generating private investments;
- ii) High costs of financing the budget deficit (high interest rates, tight credit control, low inflation, hence low inflation tax), emergence of expenditure arrears, raising costs of public debt service;
- iii) Falling competitiveness with large trade deficit and the accumulation of external debt;
- iv) Deterioration of liquidity in the economy, leading to the emergence of inter-enterprise arrears, and barter and netting-out operations.

All the above effects have deeply marked the Moldovan economy. As the government relied excessively on foreign borrowings, in the presence of money scarcity the third effect proved to be probably the most disastrous. The absence of hard budget constraint should be viewed as a component of loose fiscal policy that prevented restructuring, which led to non-cash transactions.

Budget Deficit and Aggregate Demand

In the standard Keynesian macroeconomics, fiscal deficit is the tool of stimulating economy during the period of recession. If the failure of private agents to consume and invest enough to meet the production capabilities is the cause of the decline in the output, fiscal expansion can stimulate the economy by enhancement of aggregate demand, leading to the reversal of the economy towards the full employment equilibrium. This result is obviously valid only if the output is under its full employment level and if recession can be indeed viewed as the consequence of a weak demand. The evolution of Moldovan GDP exhibits 70% fall within the period 1990-1998 (Figure 2.1). Did it constitute the case for the fiscal expansion? It might be difficult to argue that the economy needed a fiscal contraction. The analysis of the composition of Moldovan GDP brings the response to this question (Figure 2.3).

As it can be seen, the share of final consumption in GDP was steadily growing and increased from 80% of GDP in 1995 up to 102% of GDP in 1998. However, the rate of investment in the economy did not fall significantly and fluctuated around 25% of GDP throughout the period. This was possible only through substantial external borrowings that offset domestic dis-saving.

Clearly, throughout this period Moldova was significantly credited by its trading partners, which is reflected by the increasing trade deficit (8% in 1995, versus the near-collapse level of 28% in 1998). Such trade imbalance induced an extreme risk to the external position of Moldova and made it very vulnerable to changes in the pattern of capital flows. It is interesting to see what is the role of government consumption in this process (Figure 2.4).

Somehow surprisingly, it was the private consumption that was growing very fast (as measured as the share of GDP) in recent years. In 1995 private consumption amounted to only 55% of GDP, while in 1998 this figure raised to 85%. Meanwhile, public consumption remained stable (27%) until 1997, but it dropped sharply to 18% (it is also possible that public wages and other expenditures related to the provision of in-kind social benefits for population are included in private consumption, which means that public consumption is actually under-evaluated) in 1998.

Developments of 1998 can be interpreted as the substitution of consumption of public services and goods (as education or health care) with private consumption of similar services. However, the rapid growth of private consumption between 1995 and 1998 can be explained by

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the massive drop in savings and the declining ability of state to collect taxes (leading to the raise in the share of disposable income in GDP).

There is one clear message from this analysis: the recovery of Moldovan economy will not be possible by stimulating the aggregate demand. The Keynesian solution to the current recession is completely inapplicable since the rapid growth in final consumption fuels exclusively the increasing trade deficit.

Central Bank Credit to the Government

According to the basics of the economic theory, the fiscal deficit should be limited to the level at which:

- a) its financing through domestic capital market does not distort the allocation of resources;
- b) does not require direct credits from the Central Bank for financing it;
- c) does not lead to excessive external borrowings.

In Moldova, direct NBM credits to the Government represented the main source of deficit financing in 1992 and 1993. As it is shown in Figure 2.15, the volume of those credits amounted to 6 % of GDP in 1993. The next two years this source of budget financing decreased (2.3% and 1.7% of GDP, respectively) while in 1996 it became negative, when the state started to pay back the credit to NBM. In 1997 the recourse to this source reappeared (1.6% of GDP) but in 1998 the Budget Law prohibited explicitly such a procedure. In practice, NBM gives direct credits to the government for short-term coverage of its financial needs, but such credits must be in the form of T-bills purchase by NBM.

Table 2.2. NBM direct credit to government

	1993	1994	1995	1996	1997	1998
<i>as % of:</i>						
reserve money	60	58	55	43	46	126
broad money	40	42	35	26	27	76
<i>as % of growth of:</i>						
reserve money	NA	56	49	-85	53	-1342
broad money	NA	43	23	-32	29	-498

NBM credits to the government amounted to 60% of the supply of reserve money in 1993, but this share was reduced up to 43% in 1996. Similarly, the share of credits in broad money was reduced from 42% to 23% during the same period. Until the end of 1995 the extended credit to the government caused more than half of the growth of reserve money. In 1996 the stock of money increased independently from the evolution of NBM credits. In 1997 the situation was similar to that from 1993 and 1994, with significant money growth resulting from direct deficit financing. 1998 brought more spectacular changes with plunging foreign assets of the Central Bank, which offset an important part of growth of NBM credits to the government.

It should be noted that in September-October 1998 NBM was forced to massively credit the government in order to avoid its default on treasury securities, which resulted in a very high ratio of credits to GDP (9.3%). In the spring of 1999 NBM granted 75 million lei for the agriculture works. In general the role of direct NBM credits for deficit financing was mainly determined by the availability of cheap international financing.

Domestic Borrowings: Shallow Markets

Financing the budget deficit through borrowings on the domestic capital market is favorable because it facilitates the development of the financial sector, as T-bills are usually the main instruments traded on the emerging markets. There are, however, some necessary preconditions for the development of domestic T-bill market: apart from institutional arrangements, curbed inflation, confidence in the domestic currency and a sound banking sector is required.

As it was already mentioned earlier, the Moldovan government started to place the debt instruments on the domestic market since April 1995 with the annual yield of 90% that were lowered to 20% towards 1997, as a result of the achieved stabilization. Moldova, with a level of monetization higher than in other CIS countries, had more chances to finance budget deficit through the T-bill market. Still, the domestic sources were quickly saturated, non-resident participation being allowed in order to increase the financing base. Since the beginning of 1998 the economic agents started to realize that the fiscal policy was not anymore sustainable, and therefore the interest rate spiked to 40%. Obviously, it was in part the result of the general decrease of confidence in emerging markets after the Asian crisis in 1997. In the wake of the Asian crisis the foreign participation on the Moldovan T-bills market decreased, but the importance of external factors should not be overestimated: the financial pyramid built by the government since 1995 could not be sustained, even if the sentiment of foreign investors did not change so rapidly.

The Moldovan government, through the conducted policy, entered the indebtedness vicious circle. High costs of servicing outstanding debt requiring higher borrowings at higher interest rate (increased risk premium). In 1998, the net financing from domestic capital markets remained negative.

Table 2.3. The evolution of domestic debt (% GDP)

	NBM Loans	Treasury Securities	Total
1994	5	0	6
1995	6	2	7
1996	6	4	10
1997	6	5	11
1998	11	6	18

It should be stressed again, that excessive government borrowings on the domestic markets diverted the nature of banking activities, directed almost exclusively towards servicing the state debt. High interest rate provided banks with safe profit, which discouraged their credit portfolio diversification.

External Borrowing: Towards a Debt Crisis

The budget deficit of described size, with under-developed capital markets, would usually put significant pressure on the Central Bank for increased money supply. But NBM has rejected such pressures. The exceptionally good situation in the world capital markets allowed Moldova to finance even very high deficits from external borrowings. Alternatively, it may be judged that the credibility of NBM was built on the basis of foreign financing of the deficit. Indeed, in 1996 net financing from abroad amounted to 5% of GDP in Moldova, while between 1994 and 1997, more than half of net average borrowing requirements were financed by external sources. The availability of external financing reflected the hope of international investors in the recovery of Moldovan economy, which outweighed even the fears related to the unsustainable internal and external positions. The interest rate paid on debt issued to external agents was significantly lower than on domestic markets, which led to excessive external borrowings.

The capital inflow also represented the mirror image of the constantly deteriorating

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trade balance of the country. As it was argued in the previous section, the trade balance is driven by the high share of private consumption in GDP. The major part of this consumption is the result of the budget deficit, most of the current account deficit being covered by external borrowings. The resulting debt accumulation is the main characteristic of Moldovan economy. The indebtedness rose from 14% of GDP at the end of 1993 up to 64% at the end of 1998 (excluding energy debt). However, the most important sign of the unsustainability of macroeconomic policy is the speed of debt accumulation. While the rapid increase of indebtedness in 1998 was the result of currency devaluation, in 1997 this was the result of shortsighted policies regarding the external indebtedness. Since the consumption is the driving force in this process, the share of FDI in capital inflow is insignificant. Foreign participation on the T-bill market was close to 40% at the end of 1997. Obviously, this means also a pressure on the exchange rate, leading either to currency appreciation, or increased money supply (Central Bank buying currency in the forex market).

Table 2.4. External Debt by Creditors (million US\$)

	1993	1994	1995	1996	1997	1998
Total debt (IMF included)	173.8	505.9	665.1	800.4	1030.1	999.4
Total public debt	86.4	343	434.7	552.6	796	823
Direct public debt	86.4	343	416.9	506	710.2	716.3
Multilateral creditors	59.3	158.4	203.4	221.1	257.1	293.4
World Bank	28.6	95.7	145.8	145.8	185.7	216.9
EBRD				0.3	5.2	6.1
EU	30.7	62.7	57.6	75	66.2	70.4
Bilateral creditors	19.8	162.7	177.3	173.9	155.7	157.4
Japan		29.7	37.8	33.4	30	33.7
Russia		93.4	90.3	78.8	64	62
USA	19.8	39.6	49.2	61.7	61.7	61.7
Commercial creditors			15	90.7	277.3	245.2
Commercial banks			15	60.7	32.3	30.2
Eurobonds				30	105	75
Gazprom					140	140
Commodity loans	7.3	21.9	21.2	20.3	20.1	20.3
Publicly guaranteed debt			17.8	46.6	85.8	106.7
Multilateral creditors			8.4	33.1	45.7	53.4
EBRD			8.4	33.1	45.7	53.4
Commercial creditors			9.4	13.5	40.1	53.3
IMF	87.4	162.9	230.4	247.8	234.1	176.4

As it can be seen from the above tables, Moldova is confronted not only with an increasing debt, but also with an unfavorable structure of that debt. Since Moldova repeatedly failed to achieve the conditionality criteria, IMF stopped disbursements in the mid 1997 and this decision was followed by the World Bank, which suspended its Structural Adjustment Loan II. Since 1994 the debt towards bilateral creditors has been fairly constant. In this situation the part of debt that was increasing at the fastest pace since 1996 was the short-term commercial debt. The proceedings from Eurobonds launched in 1996 (US\$30m) and in 1997 (US\$75m) were used only to cover the budget deficit. However, the most important and least controllable source of debt accumulation is the energy sector debt. Lack of restructuring in this sector resulted in a large debt towards Gazprom (US\$140 million in 1997 and US\$90 million in 1998).

Additionally, the dependence on external financing induces a greater threat on macroeconomic stability than domestic financial obligations, as it makes the economy increasingly vulnerable to changes in perceived creditworthiness. Namely, the external debt payment stream is subject to:

- the risk of currency depreciation, which increases the debt burden;

- the risk of a shift in market sentiment, which determines the lenders to require higher interest rates to extend new credit for rolling over the existing debt (e.g. several treasury bills spikes across CIS that reflected the failing confidence preceding the Russian crisis);
- the risk of a negative impact of external financial crisis.

The risk of devaluation is extremely high when the external debt is high. The Asian crisis in the 1997 and especially the deterioration of the economic situation in Russia led to an explosive path of public debt. As a result, the financial adjustment burden for Moldova was getting higher and higher.

Servicing the Debt

The assessment about the volume of external borrowing must not be conducted separately from its utilization in terms of future income generation. The growth potential of Moldovan economy was not enhanced, as the funds were not directed to productive investments, but to the inefficient state sector. Moreover, borrowed money was not spent on structural reforms that would have limited the primary deficit of the budget. Externally financed government consumption possibilities undermined the incentives for reform implementation. Such a policy led to increasing difficulties of debt servicing. The cost of servicing the debt increased to 4.8% in 1998, from 4.2% in 1997.

Table 2.5. Debt Service versus Exports and State Revenues

Ratio between debt service and:	1993	1994	1995	1996	1997	1998
<i>Exports</i>	1	2	10	6	17	28
Government Revenues	2	6	18	9	25	42

Indeed if Moldova would have met all its obligations, the external debt service would have consumed 7.5% of GDP in 1997 and 8.7% in 1998. Serious problems with servicing the external debt appeared already at the end of 1997 (Figure 2.25). While social expenditures prove to be rigid, the increase of debt servicing costs leads to the collapse of the budget and to financial instability.

Moldova had to reschedule two credits from Russia (US\$ 30 million) at the end of 1997, but in the course of 1998 it failed again to meet its obligations on this debt. The government also failed to honor some external guarantees. Payment arrears on energy supplies were developing particularly quickly and there is always the possibility that they will be converted into state debt under the pressure of energy resource suppliers. It is expected that repayments in future years will be so substantial that external financing will remain negative. As an indicator of country external exposure, the spread on Moldovan Eurobonds increased from 380 basic points to 800 at the end of 1997.

In fact, the external exposure of Moldova was already unsustainable in the first half of 1998, as the country ran into a debt trap and liquidity crisis. Similar cases appeared in other transitional countries. The Hungarian crisis from 1994, for instance, led to the rebound of inflation. This situation came after 1993 difficulties, when the budget deficit grew to 7.6% of GDP, the public debt accounted for 17.9%, current account deficit increased to 9%, interest payments reached 4.5%, and external debt went to 64%. The 1995 crisis in Bulgaria had also its indirect roots in the accumulation of debt. The National Bank of Bulgaria tried to decrease the interest rates in order to alleviate the burden of debt service. In Russia, during the pre-crisis situation from 1997 the interest payments accounted for 5% of GDP, while public debt in GDP exceeded 60%. In Ukraine, in the eve of the crisis, the public debt represented around 30% of GDP.

The Crisis of 1998: Consequences and Policy Response

The first immediate effect of 1998 crisis for Russia was the loss of confidence of foreign investors because of government inability to service the accumulated public debt. However, the crisis had much deeper roots in the lack of structural reforms, and slow pace of privatization and restructuring. These drawbacks are an expression of the permanent weakness of the state with respect to its public finances. Consequently, the negative impact of Russian crisis was more severe in case of those countries where the same underlying problems have been present.

For Moldova, the lack of structural reforms translated into unsustainable internal and external positions at the end of 1997. Such a situation leads almost always to a financial crisis, unless rapid policy adjustments are undertaken. The turmoil that followed in 1988 the Russian crisis was for Moldova a catalyst that speeded up the collapse of its fragile monetary stabilization. The capital account losses (capital flight) brought the country to the verge of default. Unfortunately, the Russian crisis had actually a deeper impact on Moldovan economy, through the abrupt and probably persistent loss of major export markets, a situation that may affect the real economic activity over a longer time period.

Pressures on Balance of Payments

Moldova is a small open economy that is very sensitive to changes in its current account developments and international terms of trade. Unfortunately, the country's exposure increased in recent years, as one partner – Russia – intensifies its domination on foreign trade. In 1997, the exports to Russia accounted for more than 60% of total Moldovan exports, compared to only 35% at the beginning of the decade. This involution is the direct consequence of a slow process of restructuring in the economy, expressing at the same time the absence of any effort to diversify the export markets. Traditionally, Moldovan producers have benefited from a privileged access to relatively low competitive Russian markets. However, this situation has impeded the development of marketing skills of Moldovan enterprises, as well as the quality adjustment of goods. On the other hand, the exports to Russia have been politically promoted in order to cover the import of energy from this country. In-kind operations having a large share in total transactions with Russia induced further negative consequences on the investment possibilities of Moldovan producers. As a result, the dependence of the economy has been rising, which allowed Russia to enhance its terms of trade against Moldova; a significant part of negative shocks faced by Russian enterprises during the transition has been therefore transferred to Moldovan firms. Consequently, the 1998 crisis determined not only a fall of exports to Russia, but also lower prices paid by Russian importers for Moldovan products. Furthermore, the price decrease reduced the profit margins of Moldovan exporters. At the same time, the Russian supply of energy is done under less favorable conditions.

With this respect, the collapse of Russian demand for Moldovan products had a devastating medium-term impact on the economy. The crisis came unexpectedly and practically froze the exports to Russia, although the situation of exporters has deteriorated since the beginning of the year 1998. In September 1998 alone the exports fell by almost 80% in comparison to the same month of the previous year and the situation did not improve until the end of the year. For the first time since early 1996, Moldova reported a negative trade balance with Russia.

As a result, the current account deficit accounted for 20% of GDP in 1998 in comparison to 14% in 1997 (Figure 2.28). The current account imbalances between 1995 and 1997 were coupled with surging capital inflows that increased twofold over the period. The change in the market sentiment following the Asian crisis, combined with the growing concern about economic developments in CIS countries, reversed the positive trend. As a consequence of Russian crisis, all countries in the region experienced dramatic outflow of private financing,

with rising interest spreads on treasury bills. Private capital available to European emerging markets (especially CIS countries) shrank significantly. In response to the crisis, foreign investors in Moldova withdrew their funds, converted them into dollars, and left the market. Domestic entrepreneurs were ready to fake external trade contracts, in order to buy dollars, while Moldovan commercial banks became involved in speculations against national currency.

Such a rapid reversal was possible due to the improvement of capital account in recent years, fuelled exclusively by portfolio inflows. These inflows increased by more than 4 folds in 1997 compared to 1996, although this was an effect of only two large transactions done in the second quarter of 1997: Eurobond placement and securitization of the debt to Gazprom. Besides, non-resident played a significant role on the T-bill market. However, the portfolio investment proved to be very volatile. The reluctance to credit the Moldovan government started at the beginning of 1998 and culminated with the massive outflow of funds after the outbreak of Russian crisis. The withdrawal from the T-Bill market was estimated at US\$ 30 million, followed by the redemption by NBM of US\$30 million of the first Moldovan private placement, issued in 1996. The receipts from IMF (quite substantial in 1995 and 1996) dropped almost to zero in 1997 and 1998, due to the halt of EEF credit line. The difficulties with respect to the loan agreements led to negative financing from the World Bank in that period. New disbursements from IMF were not made until January 1999. At the same time, foreign debt payments to IMF alone required about US\$70 million both in 1997 and in 1998.

As in many other countries, foreign direct investors proved to be the most stable source of capital inflow. In the first half of 1998 the growth of foreign direct investments in Moldova remained positive, although at a lower rate. In 1998 FDI was 20% higher than in 1997 (FDI increased threefold in 1997 in comparison to 1996). However, it should be noted that so far Moldova failed to attract substantial FDIs (only US\$ 90 million in 1998) and even their steady inflow does not compensate the flight of portfolio investment.

The deterioration of the balance of payments induced a serious financial instability in Moldova, forcing the authorities to adjust their policy accordingly. Fostering such adjustments, while avoiding social reactions has been the major objective on the agenda of the new Government in 1999.

Exchange Rate and Foreign Reserves

The BOP deterioration has determined a strong pressure on the national currency. The crucial dilemma that NBM had to consider was whether to defend the currency or to allow the market forces to determine a new equilibrium exchange rate. Two main reasons drove NBM initial decision to maintain at any cost the stability of leu in nominal terms until November 1998. Firstly, the already substantial external debt: the high cost of servicing this debt would have risen above the financial capabilities of the government. Secondly, a stable national currency was the only visible sign of successful economic reforms in Moldova: the last five years NBM managed to gain credibility through exchange rate stability. The decision to devalue the currency was therefore seen as a risk to compromise the whole financial system, which could have led to massive sales of domestic currency and therefore to the collapse of the system.

Initially, NBM tried to maintain the exchange rate through substantial interventions on the foreign exchange market (Figure 2.16). Until November 1998 the leu was maintained at an artificially high level with very harmful impact on the stock of international reserves. Despite the huge amount of hard currency sold by NBM in September – October 1998, the exchange rate (leu/ US\$) increased from 4.7 in August to 5 in mid October.

Such a policy response determined a widely spread criticism, as it was argued that the scale of Russian crisis made it impossible to maintain the existing exchange rate level. It should be also noted that between mid-August and the beginning of November the Russian ruble was devalued by 170% and the Ukrainian hryvna by 65%. A strong Moldovan leu meant therefore a real appreciation of leu against ruble, which contributed to the loss of Moldovan competitiveness on Russian and Ukrainian markets. In such a situation, the NBM policy proved

to be unsustainable: the bank ignored the warnings expressed *inter alia* by IMF and continued its efforts to support of national currency, translated into substantial losses of international reserves. Even before the Russian crisis, an alarming sign was represented by the massive sales of hard currency on the Inter-Bank Foreign Exchange. For the first time since the introduction of the national currency, NBM net transactions at the Bourse were negative for seven months (January - July 1998). During this period, NBM sales exceeded by US\$ 41million the overall amount bought on the market. Moreover, even after the crisis NBM intervened massively to defend the lei: only between August and October 1998 NBM wiped out of its reserves other US\$ 81million. Consequently, gross NBM reserves (Figure 2.17) decreased from US\$ 366 million at the beginning of 1998 to US\$ 144 million at end of the year, i.e. by US\$ 222 million (the difference comes from external debt service payments).

In the second half of October 1998 NBM decided to make another attempt to stabilize the lei raising the banks' reserve requirement from 8% to 25%. By this measure, NBM wanted to limit the demand for hard currency of the banks by diminishing their liquidity in national currency. NBM expected that the lack of lei cash would determine the commercial banks to sell hard currency on the Inter-bank market. But this did not happen and the currency continued to depreciate, approaching 6 lei per US dollars by the end of October. Consequently, starting with November 2nd, the NBM decided to stop selling hard currency at the Bourse, letting the commercial banks to determine the exchange rate by themselves. The withdrawal actually meant that NBM failed to meet the growing demand for hard currency. Since then, the official exchange rate is being set as a weighted average of the rates resulting from banks transactions for the previous day.

Facing the impossibility of commercial banks to meet the reserve requirement, NBM reduced the compulsory level to 15%, also requiring that 10% of total assets of the banks to be in the form of T-bills. Meanwhile, the national currency depreciated sharply from 6.40 lei/US\$ on November 1st to 9.71 lei/US\$ on December 1st, 1998. The exchange rate became then rather stable, mainly due to NBM strong enforcement of reserve requirements. Moreover, the lei knew a slight appreciation (8.32 lei/US\$ on January 1st, 1999) and NBM managed to buy some US\$ 16million. Then the depreciation started again, but at a slow pace. During 1999, the exchange rate overpassed 10 lei/US\$, a new equilibrium of the market being set (Figure 2.6). The non-intervention policy of NBM proved therefore to be successful. This policy should be maintained in the future, since the main concern of the Central Bank need to be building-up of its foreign exchange reserves.

Deposits in the Banking System

The commercial banks passed relatively well through the crisis because there was no substantial currency forward exposure and the debt was not largely denominated in foreign currency. Still, many months after the outbreak of crisis the banking sector faced a serious lack of funds. The initial confidence in the lei, reflected by the high level of households' deposits in domestic currency was drastically reversed at the end of August 1998, when the Russian banking sector collapsed. This event induced strong depreciation expectations in case of Moldovan population: deposits in lei decreased from 746.7 million in January 1998 to 492.6 million in January 1999, while dollar deposits doubled during the same period, meaning that a large part of savings in lei were converted into hard currency deposits (Figure 2.19). Between August and October 1998, more than lei 250 million were withdrawn from banks, while lei 120 million were converted into foreign currency. The dollarization ratio of deposits has increased from 20% in 1997 to 44% in the end of 1998.

The Inflation

In 1998 the inflation rate showed a significant shrink compared to previous years, with four months of deflation that brought the inflation rate to only 0.97% within the period January-October. The deflation had a seasonal nature (falling prices of food), but also a monetary

explanation. The cash in circulation shrank by about 25% in 1998, due to massive NBM withdrawal of lei in exchange of hard currency. However, the ulterior depreciation of leu re-fuelled the inflation. High dependence of Moldovan economy on imports, as well as the high level of dollarization, induced inflationary effects through the exchange rate movements. Prices of imported goods increasing proportionally to the exchange rate, the resulting inflationary impulse (substitution of foreign goods with domestic products, higher costs of manufacturing) increased the prices of domestically produced goods. The lower level of competition in the market - the higher the response of prices to the depreciation, so the monopolistic structure of Moldovan market made the price response immediate. Finally, depreciation induced higher tariffs for imported gas and electricity. It is important to note that a significant component of 1998 inflation was the money growth related to the NBM direct credit to the government in the fourth quarter of 1998 and at the beginning of 1999.

The T-Bills Market

As it was mentioned earlier, the volume of T-bills sales was continuously rising, but these developments were mainly the result of a wider participation of foreign investors on the market, rather than the growth of domestic financial resources. The crisis induced the collapse of demand for state securities. Foreign investors left the market despite the high attractive price of securities offered by the state. Traditionally, out of the total number of T-bills issued, 35% were bought by foreigners, 5% by local enterprises, and the remaining 60% by domestic commercial banks. As the sovereign rating of Moldova has been downgraded from "stable" to "negative", the external financing of the budget became impossible.

The returns on T-bills started to be converted into US dollars (also by domestic banks). The low demand for treasury securities induced serious difficulties in rolling-over the outstanding debt. No long-term securities were demanded, while the interest rate on shorter maturity increased sharply. In September, for instance, only 25% of T-bills offered for sale were bought. In order to alleviate the crisis of confidence, the government proceeded to a new issue of 7, respectively 14 days maturity T-bills (Figure 2.9). For the first time since 1995, the government was unable to redeem all T-Bills, and therefore unable to finance its outstanding commitments. The country was on the verge of default, no new loans from abroad being available.

In this situation, NBM had to direct a credit to the Ministry of Finance, with obvious negative impact on monetary aggregates. Since commercial banks were forced by NBM to hold a part of their reserves in T-bills (10% of total assets, later on - 5%), this helped the T-bill market to regain momentum. Year 1999 showed a slow recovery of demand for short maturity T-bills.

The External Debt Service

Devaluation means the raise of the external debt burden (i.e. dollar-denominated debt). Such a debt trap led in Latin American countries to the "lost decade" of economic stagnation. Similarly, such a considerable external debt generated the Russian crisis. In case of Moldova, where the devaluation is equivalent to a proportional increase of indebtedness, all interest and amortization payments that government needs to make require more domestic resources. This is because the tax revenues are denominated in lei, and they are not likely to rise in response to devaluation. The massive outflow of foreign investors from the market of securities (which makes impossible the rolling over of obligations), combined with the necessity to make payments in dollars, leads to a situation that is not far from the international default. The accumulated stock of external debt (including energy debt) reached US\$ 1.4 billion on January 1st 1999, which represented more than 80% of country's GDP (Figure 2.24). The share of debt service to exports rose from 14% in 1997 to 23% in 1998, and this ratio could jump to 57% in 1999. In practice, Moldova is unable to service its external debt without a strong support from international organizations.

The Impact on Real Sector

According to the official forecast, 1998 was supposed to be the second year of economic growth in Moldova, with a real GDP increase of more than 3%. However, negative tendencies started to appear in the economy since the beginning of 1998. The bad harvest in agriculture, combined with the crisis that hit the economy in the second half of the year, led to a decline of real GDP by 8.6% in 1998 (Figure 2.1).

While in the first eight months of 1998 the industrial output fell by 2%, compared to the same period of 1997, in September the decline represented 32.5%. This fall was determined by the abrupt decline of Russian demand for Moldovan products. Virtually, all industrial sectors were damaged, including the leading agro-industrial complex, which shows unfavorable prospects for the future. Since the exports to Russia are not likely to recover to the level reported in 1997, this sector will not be able to stimulate the economy in the upcoming years. On the other hand, the reorientation of exports towards Western markets will require certain time. The same time constraint applies for quality improvement of exported goods and for adopting corresponding marketing strategies.

However, the impact of financial instability on the real economy will not be large, although high interest rates impede bank lending to the private sector and discourage fixed investments. Currency and banking crises implied, on average, an accumulated loss of 14% of GDP in 26 cases of crises in the emerging economies in the period 1975-1997 (IMF, 1998 data). In case of Moldova these effects will be limited by the less significant role of bank credits and low leverage of corporate sector. Moreover, a large share of transactions is conducted on a non-cash basis. However, if the development of financial markets slows down, the inefficiency in supplying the funds that are necessary for restructuring purposes may hamper the long run growth of the economy.

Impulses for Further Reforms

It might seem odd, but the Russian crisis had some positive influences on the economic reforms in Moldova. The crisis forced the authorities to start thinking about solving the fundamental problems of the country, mainly related to the lack of structural reforms. A critical situation makes the public more likely to accept the painful measures that are necessary to revert the negative tendencies accumulated in recent years. The fact that the state failed to deliver basic services is a credible reason for radical reforms; the population may indeed believe that the government has no other choice but to change immediately the situation. The large external debt makes the country fully dependent on the co-operation with international organizations, especially the IMF. It should be also noted that the developments of the crisis in Moldova were more similar to those in Ukraine rather than in Russia. Specifically, Moldova did not announce the default and the banking sector remained relatively stable. It may be therefore possible that the post-crisis evolution in Moldova will be close to the Bulgarian experience, where the financial crisis from 1997 induced the adjustment of economic policy with restrictive fiscal stance. The acceleration of structural reforms allowed Bulgaria to restore the growth in 1998, unlike Russia where the fiscal policy was further loosened, financial discipline weakened, and structural reforms abandoned.

A window opportunity for accelerating Moldovan reforms emerged therefore from the crisis, and the Sturza government approached more seriously the budgetary problems. The government adopted a relatively more austere (but not fully feasible) budget for 1999, prepared under the IMF recommendations. Significant institutional changes were also envisaged. The custom offices with Transnistria were introduced in order to fight the smuggling phenomenon. The unification of VAT regimes has been introduced since January 1st, 1999. At the same time, the Moldovan government committed to abolish non-cash tax payments.

Somehow surprisingly, the crisis may have also a positive impact on FDIs in a medium term perspective. Although the fall in confidence contributed to the deterioration of the

economic situation, the cash stripped budget and the general fall in industrial production forced the policy makers to speed up the privatization process. As a result, the state started to seek for more reasonable prices for enterprises offered for sale, which determined the successful execution of some transactions. Previous governments were very reluctant to sell the state property and therefore only 20% of planned privatizations were concluded in 1997 and 1998.

Similarly, the decline of exports to Russia forced Moldovan enterprises to search new export possibilities. At the same time, the devaluation of national currency facilitates the penetration of non-CIS markets. Indeed, many companies are trying to enter non-traditional western markets, struggling to enhance its competitiveness and finding market niches. The Moldovan economy reports an improvement of trade with non-CIS countries and a declining significance of the exports to CIS-countries.

Table 2.6. Exports of Moldova to Selected Countries (US\$ million)

	1998 Q1	1999 Q1	% change
Russia	104.6	32.2	-69%
Ukraine	12.6	7.2	-43%
Romania	13.0	9.4	-28%
Other Non-CIS	3.3	10.4	215%
CE economies			
Non-transition economies	31.0	31.4	0%
Total	176.0	100.6	-43%

Evolutions in 1999

Economic situation in the first nine months of the current year has been characterized by tendencies of stabilization, although a weak one, both at macro and micro levels.

According to CISR forecasts, real GDP is expected to fall by some 2.5% in 1999, resulting in a more than 40% drop in GDP since 1993. Thus, global domestic product recorded a 7.8% decrease in the first quarter, while for the first half of the year it was already 5.3%. It means, that the second quarter realized a real growth, which allowed to lower the drop in the first quarter. In January-September 1999 the decline in industrial production was 12.8% comparing to the same period of 1998 (for the first 3 months of 1999 the decline was 27%). Similarly, for the same period the agriculture production has diminished by 7% (for the first 3 months it was 11%).

Trade balance deficit of Moldova has significantly reduced in January-September 1999 reaching US\$80.8m (for the same period of last year it was US\$328m). For the first time in last years the second quarter showed a US\$2.32m surplus in the BOP current account. CISR estimates indicate a US\$70m trade balance deficit for 1999 (Figure 2.29) with a current account surplus at some US\$10.

However, both exports and imports have shrunk considerably. Total exports in the first half of 1999 have decreased by 44% as compared with the same period of 1998. But the structure of exports does not show anymore a prevalence of a single market i.e. the Russian one. In 1998 exports to Russia accounted 59% of the total. At present, share of Russian market is only 38.4%, while 53.9% are exports to Central and East Europe. Now we can see that after the financial crisis the Moldovan exports managed hard to reorient towards more stable markets (Figure 2.30 and Figure 2.31). Export to the EU countries grew by 17.2%, to the Central and Eastern European countries – by 23%, while export to CIS countries decreased by 55%.

Essential changes showed the imports as well. During first six months of 1999, total imports have decreased by 56.3 %. In the structure of import there is no longer domination of CIS (40.1% of the total import). It is obvious that, although the total volume of import is decreasing, the structure of import shows a growing share of energy imports.

2. MACROECONOMIC TRENDS: DEFERRED STABILIZATION

The new government managed to restore the collaboration with international financial institutions. In 1999 Moldova has received new loans from the IMF (US\$35m+US\$35m) and World Bank (US\$30m+US\$20m). Along with successful repayment of foreign obligations, there were also negotiations held regarding the rescheduling of some foreign debt. An extremely important step was the redemption by the government of securities issued to Gazprom, annihilating US\$140m of the country's external debt.

Although the general expectations were more pessimistic, the steady evolution of leu in 1999 (letting alone the usual seasonality of leu, influence of political factors, or currency speculations), and particularly the remarkable stability of leu in June-September, proved the credibility of the monetary policy implemented by BNM. Thus, the bold CISR forecast of the end-year exchange rate as 11.58 lei/1 dollar (optimistic scenario, Economic Survey No. 3) set in April 1999 proved to be quite close to the reality. The nominal exchange rate showed a depreciation from 8.32 (1 January 1999) to 11.64 (21 December 1999) lei per 1 US dollar (Figure 2.6), therefore the end-year rate could well be at 11.7 lei per 1 US dollar. The evolution of the real exchange rate of leu followed the same path as the nominal one. Depreciation of leu in real terms is estimated to be close to zero in 1999.

Cumulative level of inflation for January-November 1999 was 36.9%, thus we could expect for 1999 an inflation rate at about 40%. Monetary aggregates started to increase again (Figure 2.12), after the considerable fall in the 4th quarter of 1998. Cash in circulation grew from 855 million lei at 1 January 1999 to 1074 million lei at 1 October 1999, i.e. by 25%. The inflationary part of this increase was as usual driven by NBM's loans to the Government, while the non-inflationary component was driven by purchases of hard currency surplus in the market done by NBM - US\$54m during January-September. It should be stressed, that these interventions did not have a harmful impact on the exchange rate.

Broad money has increased by 40% in January-September, reflecting a 53% growth in deposits with banks. The share of deposits in foreign exchange continued to increase – dollarization of banks' deposits rose from 44% to 52% at the end of September (Figure 2.19). This shows still strong depreciation expectations in case of Moldovan population, which prefers to hold deposits in dollars. But this loss of confidence in leu is not accompanied by a similar attitude towards the banking system – a real proof to it is the overall increase in deposits.

With the beginning of 1999 a slow recovery of demand for T-bills (mainly short maturity ones) started. With the new Government in place since March 1999 and the new path of reforms, the confidence in the government's securities market has increased. Thus, there has been a continuous increase in the volume of T-Bills sold, along with the gradual decrease in interest rates. The volume of sales of T-bills during the first 9 months almost doubled – from 93 million lei in January to 195 million lei in September (Figure 2.11). During September-October the tendency of decreasing interest rates on T-bills took a firm stance, and only during 2 weeks the average rate fell two-folds reaching the level of 14.2%. The government took a bold stance refusing to increase the amounts of sold T-Bills (in spite of the growing demand for them in the market) and aiming at reducing the internal debt. Obviously, this could in the end lead to a more active involvement of commercial banks in crediting the real sector of the economy.

Table 2.7. Main Macroeconomic Indicators

	1994	1995	1996	1997	1998	1999e
Real GDP growth rate	-30.9%	-1.4%	-7.8%	1.6%	-8.6%	-2.5%
Nominal GDP (excl. Transnistria), lei million	4737	6480	7658	8917	8804	11926
Nominal GDP, USD million	1164	1443	1665	1933	1630	1137
GDP per capita, USD	322	400	463	538	454	316
Annual inflation rate (end period)	104.6%	23.8%	15.1%	11.2%	18.3%	40.4%
Average inflation rate	487.0%	30.0%	24.0%	12.0%	7.7%	38.9%
Consolidated general govt. revenues, lei million	1848	2556	2835	3473	3505	3607
Consolidated general govt. expenditures, lei million	2348	2993	3418	4165	3804	4230
Budget balance, lei million	-281	-437	-583	-692	-299	-623
Budget balance as % of GDP	-5.9%	-6.7%	-7.6%	-7.8%	-3.4%	-5.2%
Internal debt, million lei	270	477	737	940	1500	1700
Internal debt, USD million	63	106	158	202	180	145
Stock of foreign debt*, USD million	627	765	921	1008	954	841
Stock of foreign debt as % of GDP	53.8%	53.0%	55.3%	52.1%	58.5%	74.0%
New borrowing*, USD million	247	196	195	197	85	180
Debt servicing (principal+interest)*, USD million	24	65	54	141	174	324
NBM gross forex reserves, USD million	180	257	314	366	144	202
NBM reserves in months of imports of GFS	2.87	3.04	3.00	3.07	1.40	3.46
NBM net forex reserves, USD million	17	29	71	132	-27	28
Cash in circulation M0, million lei	345	639	731	972	855	1100
M2, million lei	676	1107	1292	1739	1357	1780
Broad money M3 (at current exchange rate), million lei	749	1244	1439	1929	1756	2502
Money multiplier	1.36	1.59	1.68	1.72	1.66	1.73
Dollarization of deposits	18.2%	22.6%	20.7%	19.8%	44.2%	51.4%
Monetization of the economy	15.8%	19.2%	18.8%	21.6%	19.9%	21.0%
End-year exchange rate, lei/1USD	4.27	4.50	4.65	4.66	8.32	11.69
Average exchange rate, lei/1USD	4.07	4.5	4.6	4.6	5.4	10.5
Nominal end-year annual appreciation(+)/depreciation(-), MDL/USD	-17.3%	-5.4%	-3.4%	-0.2%	-78.6%	-40.5%
Nominal end-year annual appreciation(+)/depreciation(-), USD/MDL	-14.8%	-5.1%	-3.2%	-0.2%	-44.0%	-28.8%
Real end-year annual appreciation(+)/depreciation(-)	+74.4%	+17.5%	+11.4%	+10.9%	-33.8%	-0.1%

* Included loans from IMF, WB, EBRD, EU, USA, Russia, other creditors, Eurobond issues, but energy debt is not present here

Table 2.8. Balance of Payments

USD million

	1994	1995	1996	1997	1998	1999e
Current account	-92	-115	-188	-269	-333	11
Current account, as % of GDP	-7.9%	-8.0%	-11.3%	-13.9%	-20.4%	1.0%
Trade balance	-54	-55	-252	-345	-399	-70
Exports (fob)	618	739	823	890	644	470
Exports, yr/yr	--	119.6%	111.4%	108.1%	72.4%	73.0%
Imports (fob)	672	794	1075	1235	1043	540
Import, yr/yr	--	118.2%	135.4%	114.9%	84.5%	70.0%
Services, net	-46	-96	-64	-62	-73	-60
Income, net	-16	-29	55	62	41	21
Current transfers, net	24	65	73	76	98	120
Capital and finance account	93	71	170	324	-2	-26
Direct Investment	18	73	23	71	86	80
Foreign direct investments, as % of GDP	1.5%	5.1%	1.4%	3.7%	5.3%	7.1%
Portfolio investment, net	0	0	54	237	-55	-131
Eurobonds	0	0	30	75	-30	0
Gazprom	0	0	0	140	0	-140
T-Bills	0	0	24	14	-35	5
Medium and long-term loans, net	157	73	101	11	40	25
Disbursement	175	131	133	101	83	110
World Bank	67	50	0	38	32	50
EBRD	0	5	34	23	15	20
Other official (EU, USA, Rus.)	108	49	46	13	21	20
Private creditors	0	27	53	27	15	20
Amortization	-18	-58	-32	-90	-43	-85
Other capital flows, net	-82	-75	-8	5	-73	0
Errors and omissions	-105	-10	17	11	24	0
Overall balance	-104	-54	-1	66	-311	-15
Financing	110	56	1	-66	311	15
Use of IMF credit	72	65	25	1	-64	3
disbursement	72	65	32	21	2	70
amortization	0	0	-7	-20	-66	-67
Change in NBM's gross reserves	-102	-77	-57	-52	222	-58
Debt arrears and rescheduling	140	68	33	-15	153	70

Figure 2.1

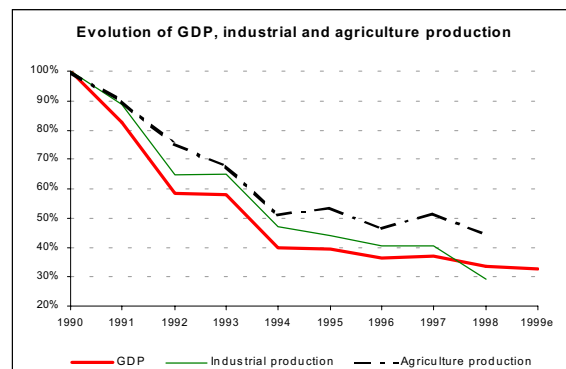


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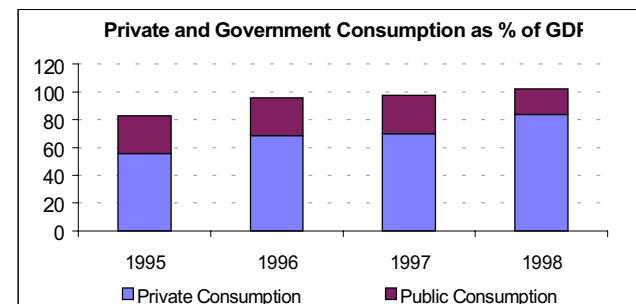


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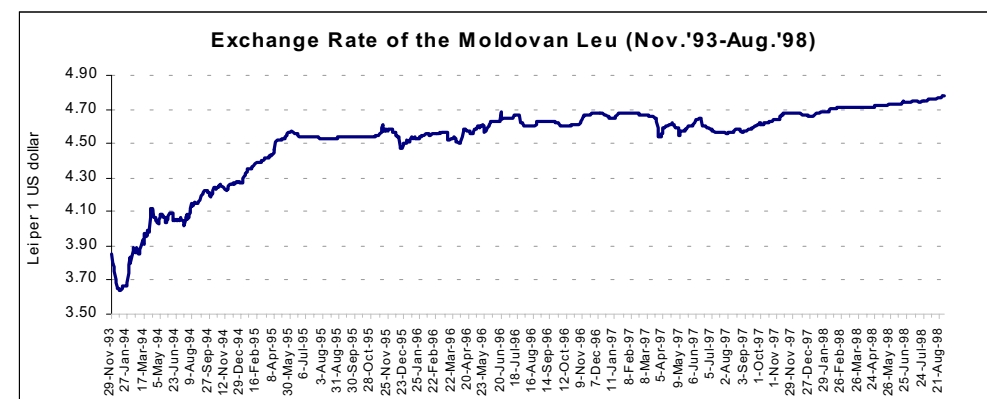


Figure 2.6

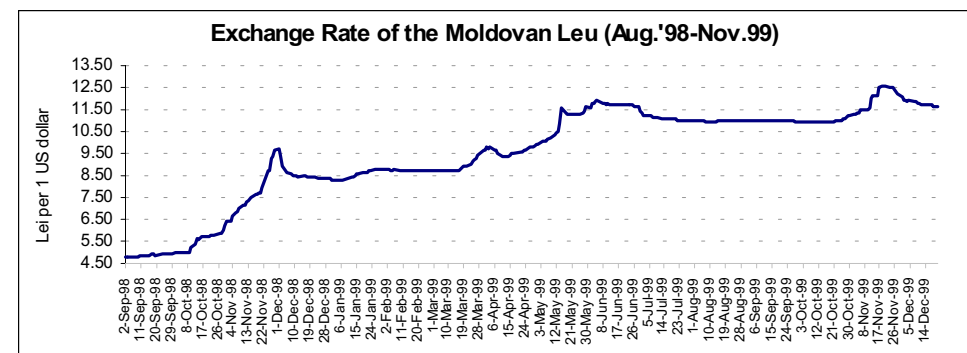


Figure 2.2

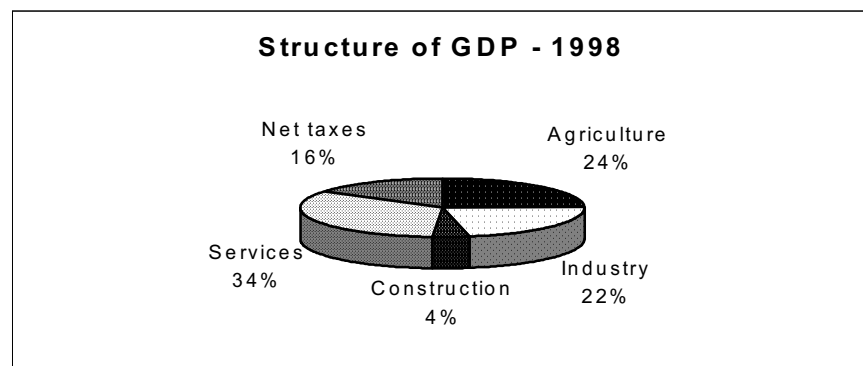
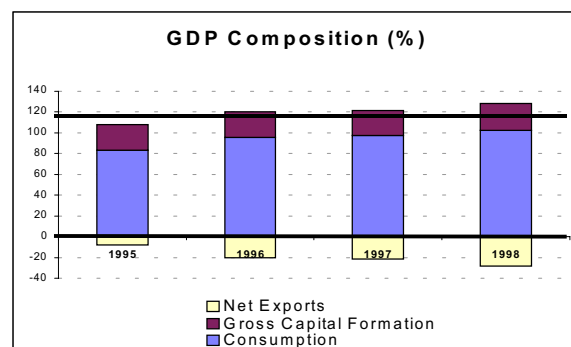


Figure 2.3



2. MACROECONOMIC TRENDS: DEFERRED STABILIZATION

Figure 2.7

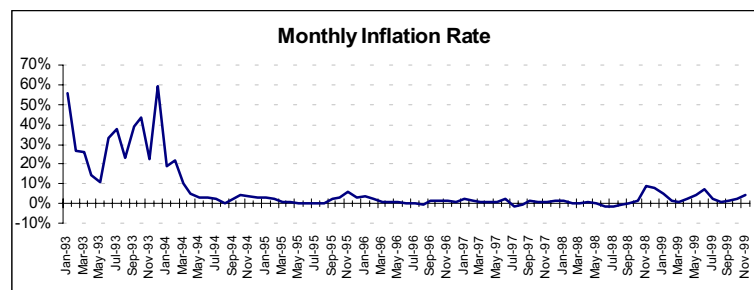


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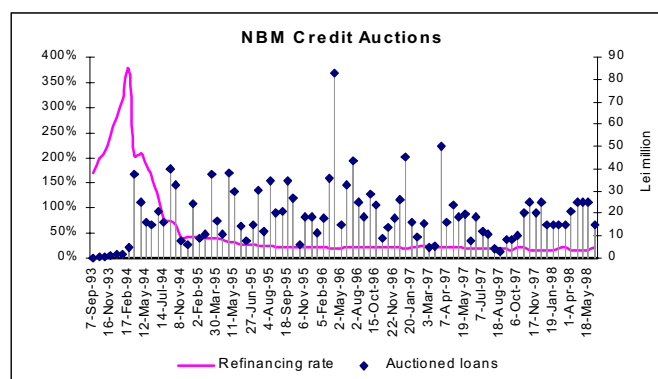


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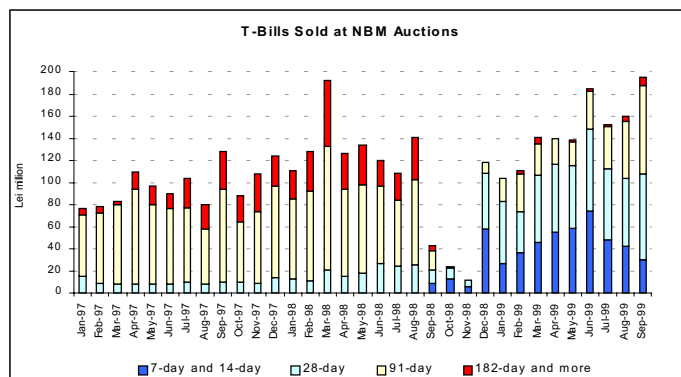


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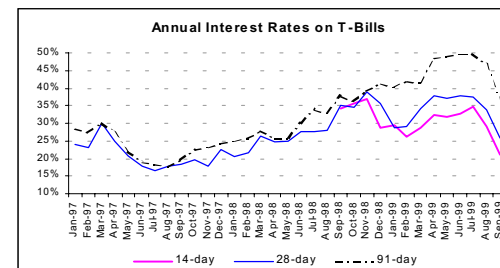


Figure 2.11

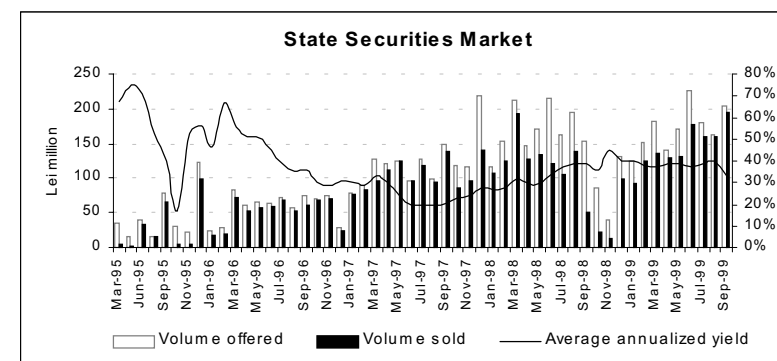


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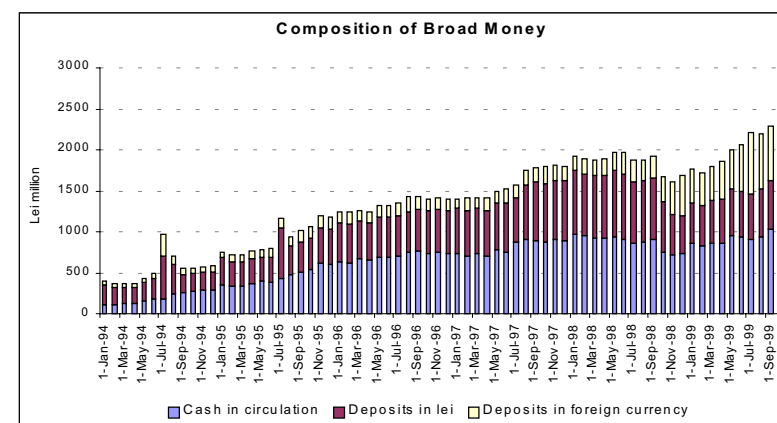


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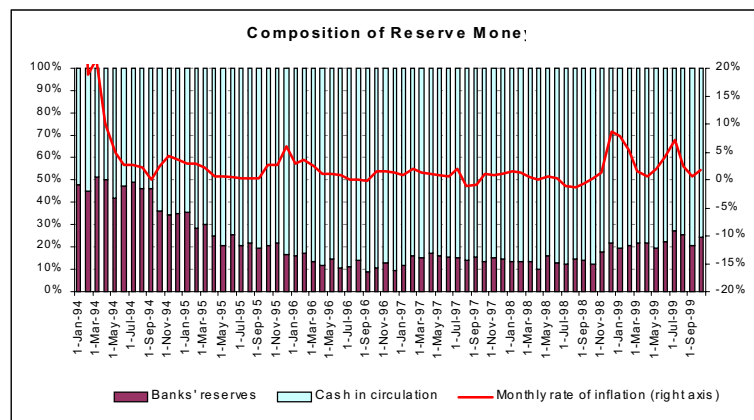


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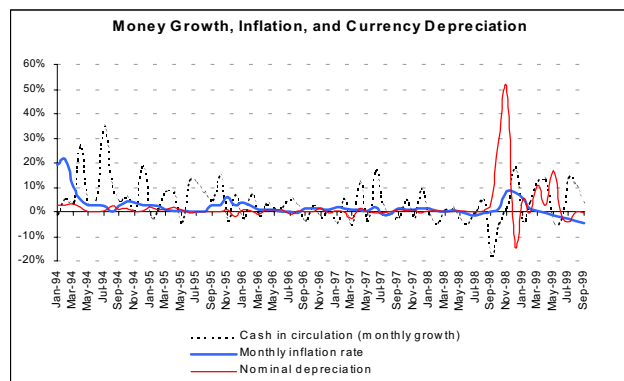


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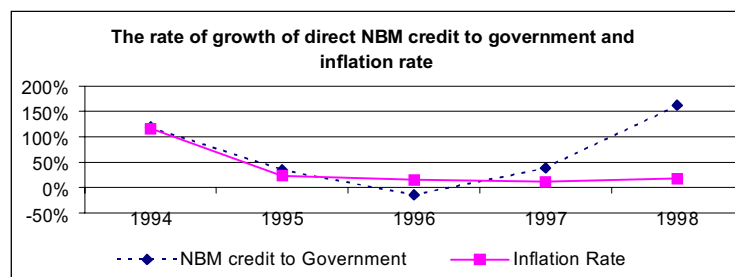


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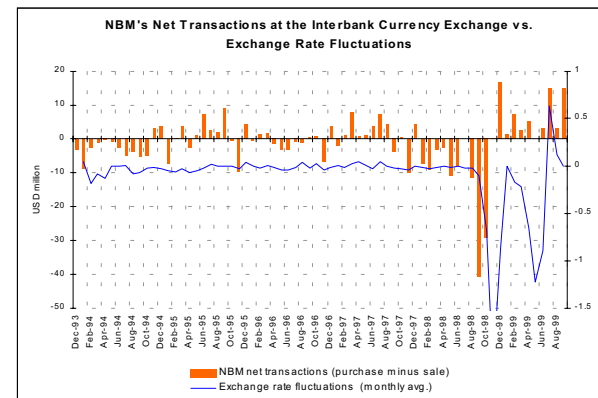


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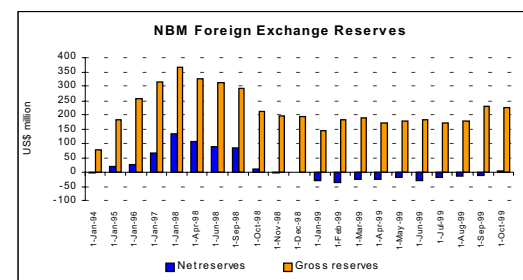
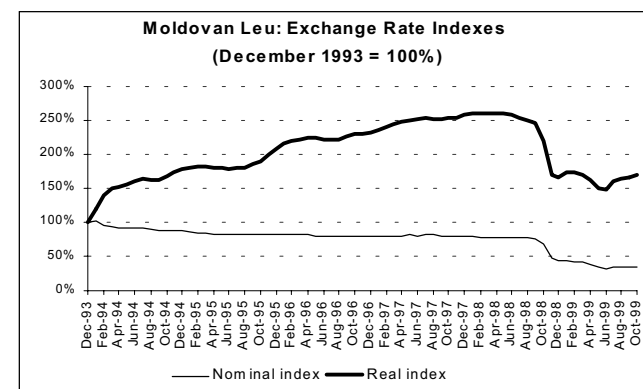


Figure 2.18



2. MACROECONOMIC TRENDS: DEFERRED STABILIZATION

Figure 2.19

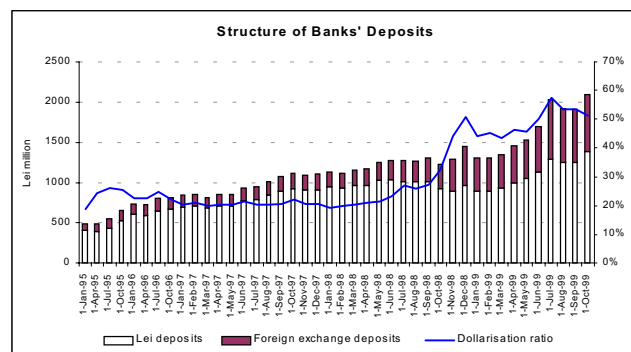


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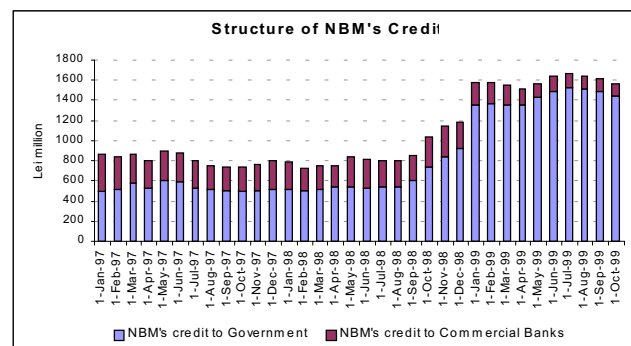


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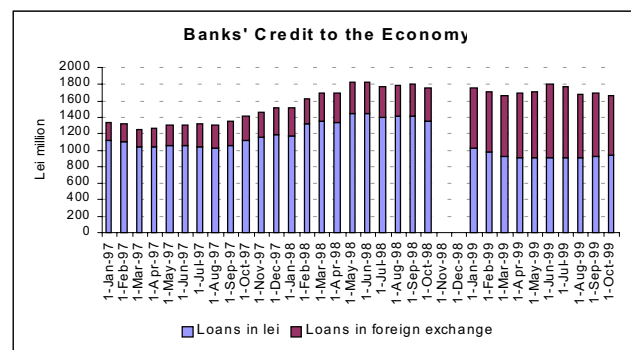


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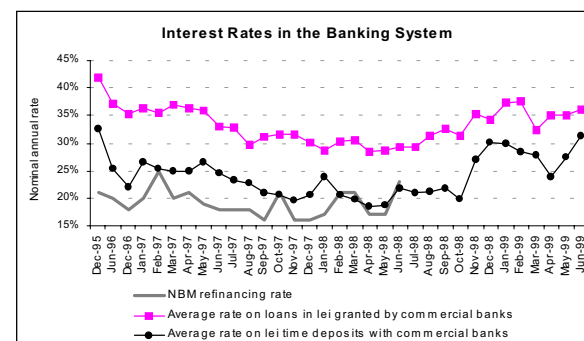


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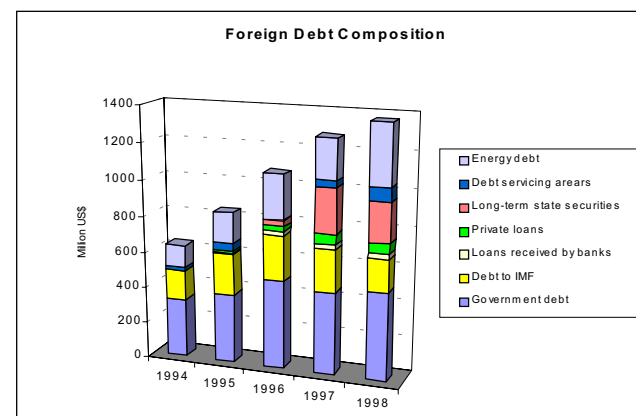


Figure 2.24

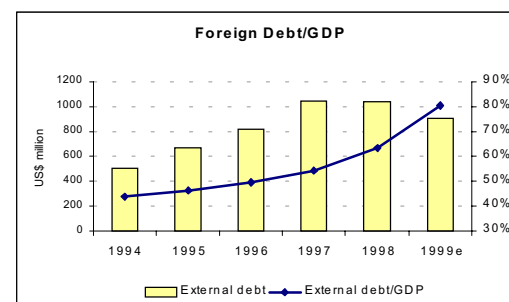


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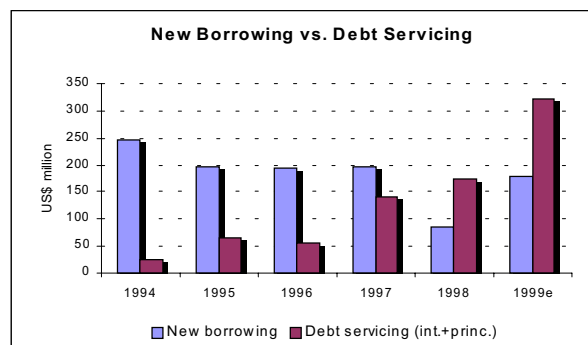


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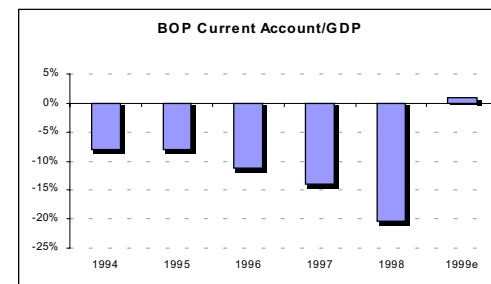


Figure 2.26

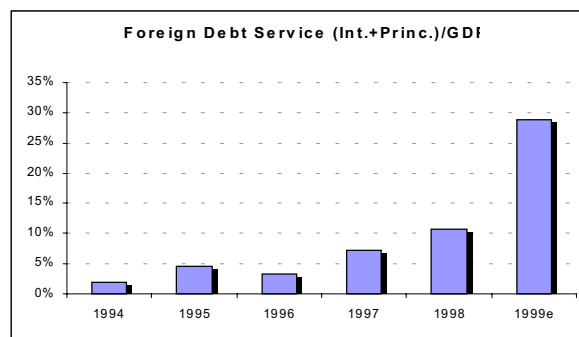


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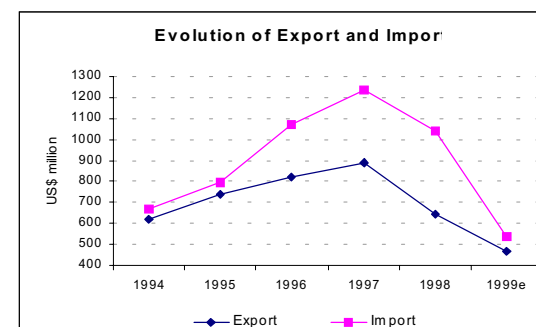


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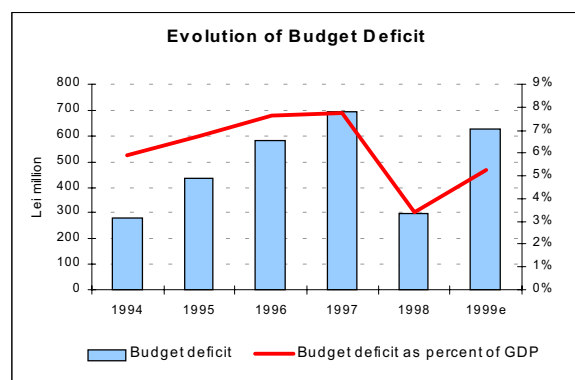


Figure 2.30

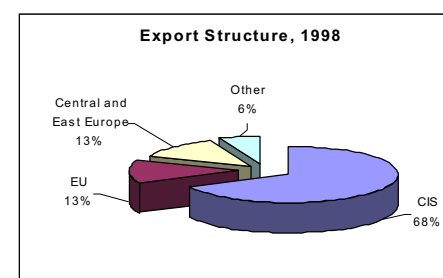
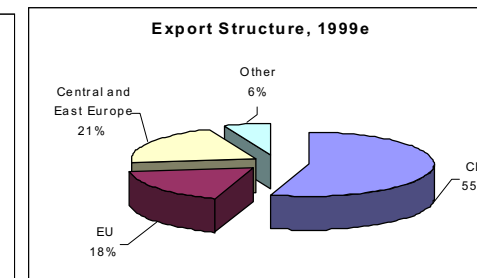


Figure 2.31

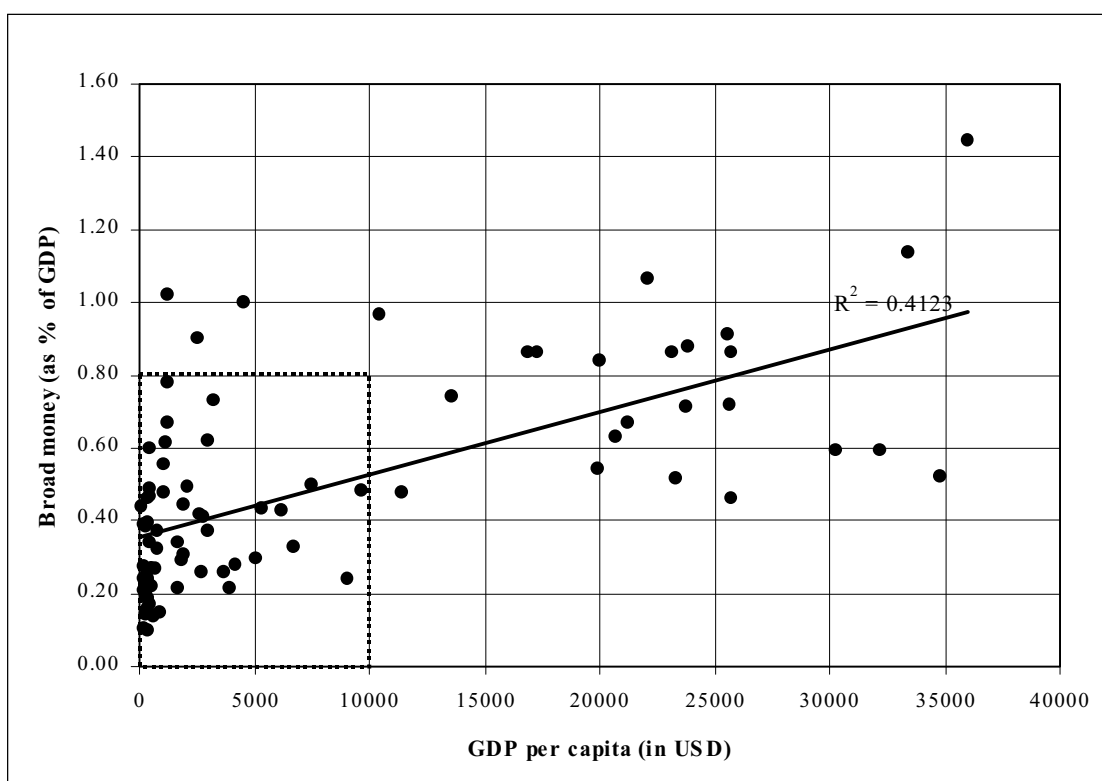


3. MONETIZATION OF THE MOLDOVAN ECONOMY

Monetization in Moldova in comparison with other countries

Money and credit tend to play a greater role in more developed countries, than in less developed ones. Rich countries are more stable: they tend to have (or can afford) more efficient tax administrations and usually have less urgent budget needs, which diminishes their incentives to resort to inflation tax as a way of generating budget revenues. Also, they have (or can afford) a higher level of human capital and better financial institutions, which implicates a more efficient, safer and wider use of credit. In 1997 in countries with the annual income above 10,000 US\$ per capita, the average monetization (ratio of Broad Money, including foreign currency deposits, to GDP) was 82%, while in the remaining countries – 37%. Figure 3.1 presents the relationship between per capita income and monetization graphically, with a fitted regression line.

Figure 3.1. Per capita GDP and monetization in the world (excluding transition economies) in 1997



Note: The year 1997 was chosen for the comparison, because this is the latest year for which data exists for most countries. Broad money includes foreign currency deposits, because this data is most widely available.

Source: International Financial Statistics

A simple regression of monetization on income (and a constant term) captures 40% of the variability of monetization⁵. This result has been shown to be independent of the period for which the data is analyzed⁶.

⁵ Wellisz (1995) used an analogous regression analysis to assess the level of monetization in Poland. Below his reasoning is repeated for Moldova.

⁶ See: Wellisz (1995), Jarociński (1998)

Table 3.1. Regression analysis of monetization and per capita GDP

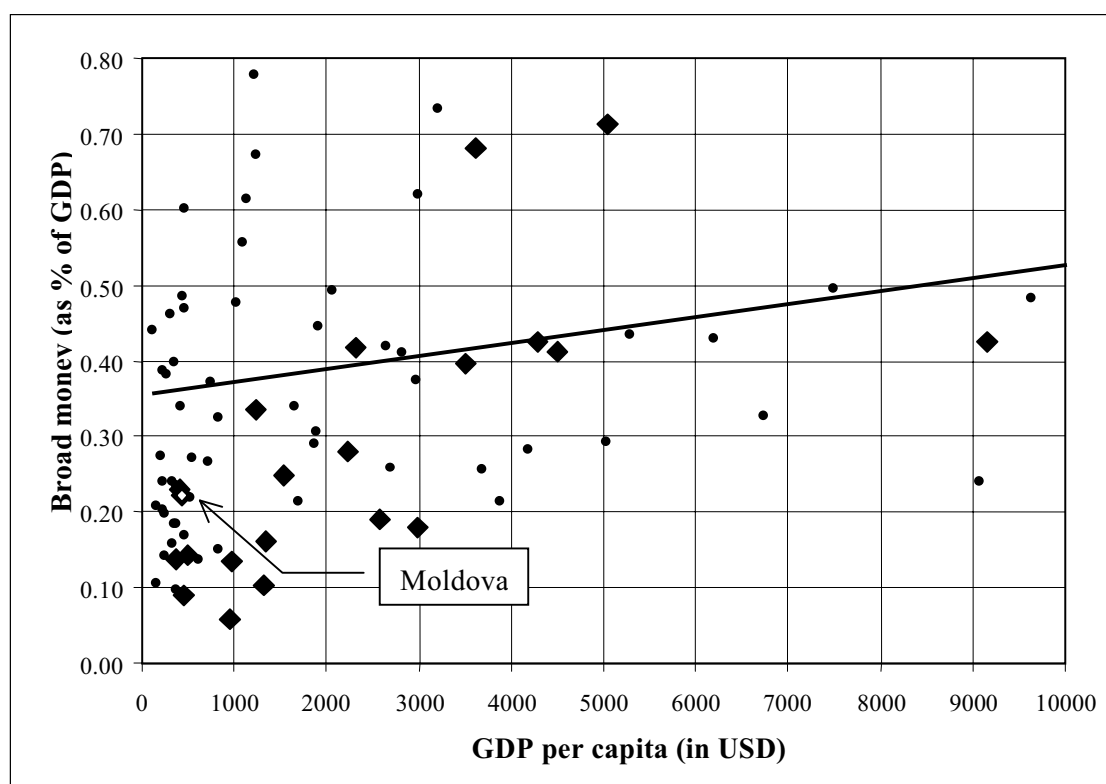
	Coefficients	Standard Error	t-Statistic
Intercept	0.36	0.029784	11.9
GDP per capita	1.72 E-05	2.28E-06	7.54
Observations: 83	Std. Error: 0.22	R ² : 0.41	Adj. R ² : 0.41

Source: own calculations

Transition economies, to which Moldova belongs, are likely to have a low monetization level at least because their per capita GDP is low. Additionally, their financial systems were being seriously developed only for the last several years. Finally, high inflation is proved to cause a fast and not easily reversible reduction of monetization⁷ and most transition countries had an episode of high inflation in the beginning of transition.

Figure 3.2 demonstrates that transition countries indeed tend to lie below the line illustrating the average level of monetization, controlled for the level of income. Monetization is especially low in the post-soviet countries (excluding Baltic states). In fact some of them (Georgia, Armenia) have lower monetization level than any other country of the world.

Figure 3.2. Per capita GDP and monetization in 1997 including transition economies – countries with per capita income below 10,000 US\$, vertical scale truncated at 0.8% of GDP



Note: Non-Transition Economies are marked with small points, Transition Economies are marked with big squares, and Moldova is marked with the big empty square.

Source: International Financial Statistics

⁷ See Ghosh (1996), De Broeck et al. (1997).

Table 3.2. Monetization in transition countries in 1997

Country	Monetization
GEORGIA	6%
ARMENIA	9%
KAZAKHSTAN	10%
UKRAINE	14%
KYRGYZ REPUBLIC	14%
AZERBAIJAN	14%
BELARUS	16%
RUSSIA	18%
LITHUANIA	19%
MOLDOVA	22%
MONGOLIA	23%
ROMANIA	25%
LATVIA	28%
BULGARIA	34%
POLAND	40%
HUNGARY	41%
ESTONIA	42%
SLOVENIA	42%
CROATIA	43%
SLOVAK REPUBLIC	68%
CZECH REPUBLIC	71%

Source: IFS

In 1997 Moldova (which is marked by the empty square) had the level of monetization at 22% of GDP, and the per capita income of 435 US\$. Monetization was lower than the average for its income level, but it was by no means an exceptionally demonetized economy. In fact, her level of monetization is one of the highest among the post soviet republics (excluding Baltic states), which are the closest 'peer group'. Even in the world perspective, Broad Money above 20% of GDP is a low indicator, but within a norm. A similar level of monetization was noted in a number of low-income countries, such as Lao People's Rep. (18%), Ghana (19%), Tanzania (20%), Madagascar (20%), Guatemala (21%), Senegal (22%). Also, monetization was not much higher in some middle income countries, which had a recent episode of high inflation, such as Venezuela (22%, per capita GDP 3880 US\$) or Argentina (24%, per capita GDP 9000 US\$)

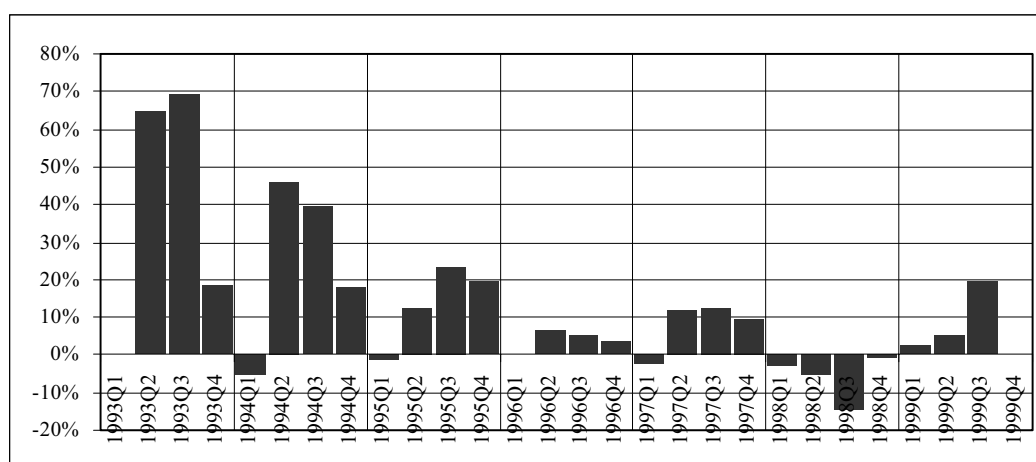
Let us now look at the dynamics of monetization in Moldova.

Dynamics of monetization in Moldova

The Problem of Seasonality

Seasonal pattern of monetization is influenced by the underlying seasonality of both the money supply and GDP figures. In most countries money supply exhibits a significant seasonality. Moldova is no exception here: M2 tends to decrease in the first quarter; its growth is strongest in the second and the third quarters and slows down in the fourth quarter. The crisis year 1998 is a striking exception from this pattern.

Figure 3.3. Percentage change of M2 in comparison with the previous quarter



Note: 1993Q1 data is missing.

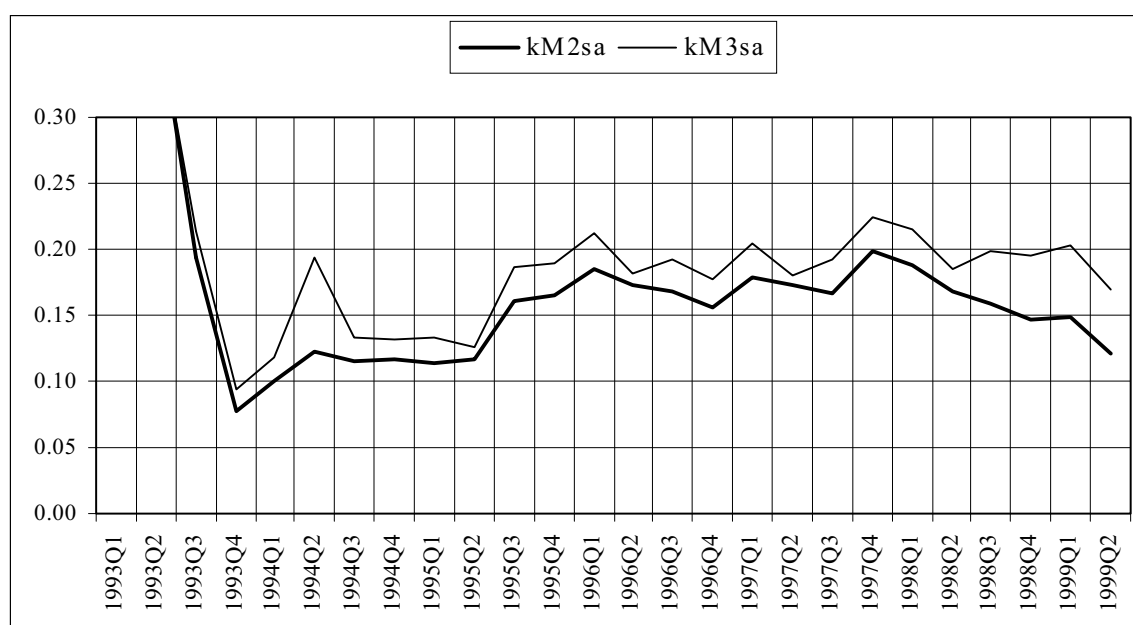
Source: Moldovan Economic Trends

However, a very pronounced seasonality of quarterly GDP data overwhelms other effects. This seasonality results from the high share of agriculture and food-processing industry in the Moldovan economy. In order to abstract from these seasonal effects and concentrate on the underlying trends in monetization, seasonally adjusted data on monetization are used further.

Remonetization Trend and Its Reversal

Monetization of the Moldovan economy has been following a typical pattern: unsustainably high in the period of a fast money supply growth, reduced sharply in the moment of stabilization and gradually growing afterwards. In 1997 Moldova reached the level of monetization, which, as figures 3.1 and 3.2 demonstrate, did not differ significantly from many low-income countries. Unfortunately, stabilization proved to be fragile and after a peak in late 1997 monetization started to decrease again. By 1999 Q2, when the effect of the regional crisis could already be felt strongly, Moldova was again close to the countries with the lowest monetization by world standards.

Figure 3.4. Monetization: share of M2 and M3 in GDP, annualized, seasonally adjusted



Source: MET data, own calculations

3. MONETIZATION OF THE MOLDOVAN ECONOMY

High monetization in the period of a fast monetary expansion prior to first stabilization attempts has been noted in all transition economies and Moldova was not an exception. The increasing rate of inflation was a signal, that this was an unsustainable situation. As soon as the rate of monetary expansion slowed down, real money balances were reduced. Slowing down of inflation rate can be interpreted as a sign that the equilibrium between money supply and demand was restored. The sustainable level of money supply, which corresponded to the demand, proved to be very low, below 10% of GDP.

In 1994-1997 a gradual growth of monetization can be observed. Abstracting from the changes in the real GDP, this means that the rate of inflation was slower than the rate of money supply growth. Part of the monetary expansion was accepted by the economy without inducing growth of prices. This process is usually referred to as a growth of the real demand for money.

In the second half of 1998 the Russian crisis stroke Moldovan economy. It is interesting to note, however, that the reversal of the remonetization trend happened already in the end of 1997 / beginning of 1998, signaling some unfavorable structural change taking place, and providing an early warning signal. This structural change can be labeled as an outflow of demand for the Moldovan leu.

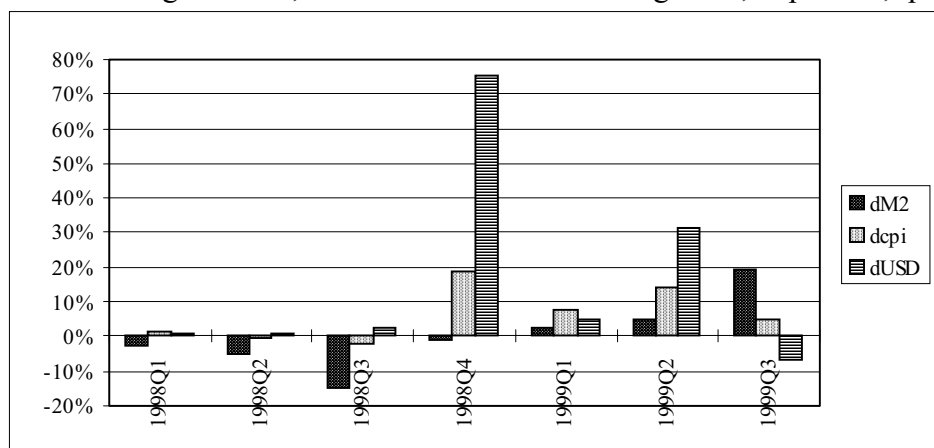
Such is the interpretation of monetization developments from the money demand perspective. Implicitly, it assumes that, once some kind of macroeconomic equilibrium is reached, money demand is the driving force behind monetization changes. According to this point of view, if money supply diverges from demand, price level reacts and brings real money supply into conformity with real demand.

An alternative explanation would concentrate on an excessively tight monetary policy as the cause of the 1998 demonetization. It is sometimes argued that prices are rigid downward and even if money supply is much below demand, they, nevertheless, cannot fall to restore the equilibrium. To check the validity of such an argument for Moldova, one should study the demonetization in 1998 from the money supply side. This analysis should help to understand whether the monetary contraction was the cause of demonetization, or a result of some other forces, which also reduced money demand.

Monetization Developments and Money Supply

The reversal of the remonetization trend happened at the end of 1997. Figure 3.4 allows to distinguish 2 distinct phases of demonetization that followed. First, since the beginning of 1998 until the third quarter of the year the driving force behind it was a monetary contraction. Then, beginning with the fourth quarter of 1998, the main factor in this process was an increased inflation which reduced real money balances. The devaluation of the leu was the cause of inflation and money supply growth lagged behind.

Figure 3.5. Changes of M2, CPI and MDL/US\$ exchange rate, in percent, quarterly



Source: MET

Table 3.3 presents contributions of separate components of money supply to changes in Broad Money. Contraction of currency in circulation was initially the most important factor of money supply reduction. It slowed down in the second half of 1998, but then an outflow of deposits from banks became stronger. Lei deposits were influenced much more than foreign currency deposits. Finally, in the first half of 1999 lei deposits recovered slightly and the growth of US\$ deposits even significantly overcompensated the previous decrease. However, if inflation is taken into account, real money continued to shrink.

Table 3.3. Categories of Banking System Liabilities - Contributions to Broad Money growth (in %)

	Dec97- Jun98	Jun98- Dec98	Dec98- Jun99
Currency in circulation	-5.64%	-0.44%	3.13%
Lei deposits	-1.44%	-12.73%	2.78%
Foreign deposits	4.51%	6.90%	19.38%
in US dollar terms	4.34%	-3.19%	8.33%
exchange rate adjustment	0.17%	10.09%	11.06%
sum: Broad Money (M3)	-2.57%	-6.27%	25.30%

Source: own calculations, data from IMF, *Moldova Recent Economic Developments*, CR99/110.

Mysteriously, in the eyes of the depositors, the banking sector asset portfolio was invulnerable to the more than 70% devaluation of the leu. There was no larger scale bank run and no banking crisis. The main problem was not a fall of confidence in the banking system, but rather a fall of confidence in the stability of the Moldovan currency. Leu deposits were withdrawn mostly temporarily and later converted to foreign currency deposits. Total deposits decreased, but rather moderately.

The whole process of demonetization began with the shrinking of the currency in circulation (which is a Central Bank liability) since the beginning of 1998. It is interesting to see what were the corresponding changes on the asset side of the Central Bank balance sheet. Table 3.4 shows that the monetary contraction was caused by the shrinking of Net Foreign Assets. Later, the Table 3. shows a highly unhealthy process of a rapid increase in the credit to the government sector and a decrease of credit of the NBM to banks and of the banking sector to the private economy. This should have undermined the confidence in the stability of the economy and in the perspectives of real sector's development in Moldova.

Table 3.4. NBM Assets - Contributions to Reserve Money growth (in %)

	Dec97- Jun98	Jun98- Dec98	Dec98- Jun99
NFA adjusted	-19.4%	-81.6%	18.9%
Net Claims on General Government	1.3%	82.3%	11.0%
Credit to Banks	3.6%	-8.3%	-8.5%
Other Items (net) + adjustment	1.8%	15.7%	-3.5%
sum: Reserve Money	-12.6%	8.1%	17.8%

Note: NFA (Net Foreign Assets) contributions have been decreased by the valuation adjustment (adjustment for the change in the leu value of dollar assets caused by the devaluation), which was added to Other Items.

Source: own calculations. data from IMF. *Moldova Recent Economic Developments*. CR99/110.

3. MONETIZATION OF THE MOLDOVAN ECONOMY

Table 3.5. Moldovan Banking System Assets - Contributions to Broad Money growth (in %)

	Dec97- Jun98	Jun98- Dec98	Dec98- Jun99
NFA adjusted	-18.9%	-36.5%	24.0%
Net Claims on General Government	3.9%	35.0%	8.2%
Credit to the Economy	14.2%	-1.0%	1.0%
Other Items (net) + adjustment	-1.8%	-3.8%	-7.9%
sum: Broad Money	-2.6%	-6.3%	25.3%

Note: NFA (Net Foreign Assets) contributions have been decreased by the valuation adjustment, which was added to Other Items.

Source: own calculations, data from IMF, Moldova Recent Economic Developments, CR99/110.

Explaining the outflow of the Net Foreign Assets of the NBM is the key to understanding the reversal of the remonetization trend in 1997/1998. The answer can be found in the Balance of Payments. Since the beginning of 1998 a gradual deterioration of the Current Account is reported. This increased the excess demand for foreign currency. However, the Capital and Financial Account (abstracting from the use of Reserves) deteriorated too. An outflow of Portfolio investments, which had begun already in the last quarter of 1997, accelerated. The asset position under Other investment, which shows mainly non-repatriation of export receipts, increased⁸ (with the minus sign in the BOP). Part of the increase of the liabilities position reflects accumulation of arrears. All these phenomena are a clear signal of an undermined confidence in the stability of the Moldovan economy and, especially, its currency.

Table 3.6. Moldova - Balance of Payments 1997-1999, semiannually

	97H1	97H2	98H1	98H2	99H1
Current account	-148.6	-118.8	-182.3	-151.4	-14.5
Trade balance	-180.3	-164.7	-216.1	-182.4	-62.7
export (FOB)	395.2	494.4	363.9	280.2	192.5
import (FOB)	-575.5	-659.1	-580.0	-462.6	-255.1
Services	-29.7	-32.3	-34.5	-38.9	-29.4
Income	30.6	32.5	23.6	17.0	18.3
Current transfers (net)	30.7	45.7	44.6	52.9	59.3
Capital and financial account	155.0	101.5	179.3	127.1	35.1
Capital account	-0.1	-0.1	0.0	1.5	115.5
Financial account	155.1	101.6	179.3	125.6	-80.4
Financial account less Reserves	177.7	131.1	101.3	-19.0	-49.9
Direct investments (net)	30.2	41.3	45.2	41.1	11.6
Portfolio investments (net)	236.2	0.4	-12.4	-42.4	-141.7
Other investments	-88.6	89.4	68.5	-17.7	80.2
assets (net)	0.5	0.2	-22.8	-26.3	-35.5
liabilities (net)	-89.1	89.2	91.3	8.6	115.7
Reserve assets (net)	-22.7	-29.5	78.0	144.6	-30.4
Errors and omissions	-6.3	17.3	3.0	24.3	-20.6

Source: National Bank of Moldova

Foreign assets of the National Bank started to leak out in the beginning of 1998 because of the shortage of foreign currency on the market. As follows from the above analysis, the shortage was induced not only by the negative trade balance – in principle, it could have been financed by a capital inflow (as it usually happens). The problem seems to be that the exchange rate started to be perceived as not sustainable. This could be due to the deterioration of the trade balance or due to the situation in the government finances. As a result, capital inflow into Moldova slowed down and outflow accelerated.

⁸ See: A comment on the Balance of Payments data for 1998 in the NBM internet site: <http://www.bnm.org>

The above analysis suggests that monetary contraction in 1998 was not a cause of demonetization, but rather a result of a structural shift of demand towards foreign currency, away from the Moldavian leu. This shift of demand can be interpreted as reflecting an increased uncertainty regarding the future value of the leu, a decrease of confidence in this currency.

Monetization and Confidence in the Moldovan Leu

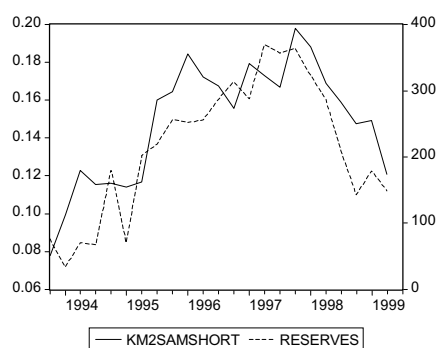
Monetization and Other Indicators of Confidence in the Leu

Further this paper attempts to interpret developments in money demand and monetization in Moldova in connection with the issue of confidence in the stability of the value of the Moldovan leu. To ground the validity of this reasoning, one can check the empirical relationship between monetization and other variables related to confidence.

International Reserves

There are two links between the gross international reserves and monetization. One of them is, that when the Central Bank has a higher level of reserves to back up the domestic currency, people have more confidence in its stability and are more willing to hold it. However, this interpretation alone would be an oversimplification, because there is also a direct link between foreign currency reserves and money supply. The NBM increases the money supply by buying dollars in exchange for leu and vice versa. Thus, the direction of causality here is trickier to determine and all that remains is to recognize the strong correlation between the two variables in Moldova.

Figure 3.6. International reserves of the NBM, in US dollars and monetization (M2/GDP), annualized



Source: MET data, own calculations.

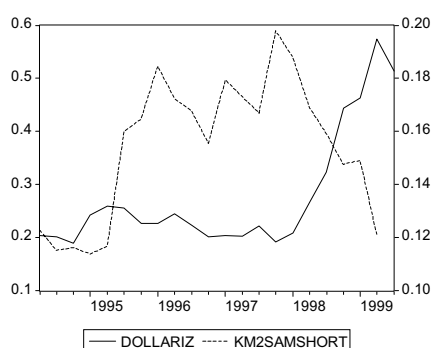
Dollarization of deposits

Dollarization of deposits can be interpreted as another indicator of confidence in the domestic currency – the less people trust domestic currency, the higher share of their savings they will choose to keep in foreign currency. Figure 3.4 presents the behavior of dollarization and monetization.

The size of the coefficient of correlation varies strongly (between -0.2, which can be regarded as insignificant, and -0.7) depending on the examined sample range. The growth of monetization in early 1995 was not accompanied by proportional changes in dollarization. Afterwards, for 2 years a negative correlation was present (coefficient around -0.6 in 1995Q1 - 1998Q1). Finally, the reversal of the remonetization trend in early 1998 was accompanied by a rapid and unprecedented growth of dollarization.

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Figure 3.7. Dollarization of deposits (share of foreign currency deposits in total deposits) and monetization (M2/GDP), annualized



Source: MET data, own calculations.

It can be concluded, that the dynamics of the level of monetization was broadly similar to the dynamics of at least two other variables connected with the confidence in the domestic currency.

A Simple Model of Public Confidence in the Stability of the Moldovan Leu

There exist no surveys of public expectations regarding the exchange rate in Moldova. Thus, statements about the level of confidence in the national currency and its influence on other variables are only speculations. Let us engage in such a speculation, stating clearly all the underlying assumptions.

The starting point of the analysis is a money demand function. For simplicity, let us abstract from the effect of interest rates on money demand. Assume that the alternative investment is in cash US dollars and the depreciation of the exchange rate is the opportunity cost of holding domestic money. Therefore, consider a money demand function of the form:

$$\ln M - \ln P = a + k \ln y - n E \{de/e\} \quad [1]$$

where M is a money aggregate, P – price level, y – real GDP, e – exchange rate (MDL/US\$) and $E \{de/e\}$ is the **expected rate of depreciation**.

The National Bank of Moldova considers national currency stability as one of its primary goals⁹ and for most of the period it intervened in the foreign exchange market in support of the leu. Therefore, the **expected rate of depreciation** can be expressed in terms of the credibility of the National Bank commitment to stabilize the exchange rate. Let us express the **expected rate of depreciation** as a weighted average of the stability scenario (i.e. depreciation rate equal to zero) and a depreciation scenario (say, that the exchange rate will depreciate enough to reverse all the real appreciation, which occurred since the time just before stabilization, the latest moment when the exchange rate had been free floating for a longer period of time).

Then in the time period t , the expected rate of devaluation is:

$$E \{de/e\} = \theta * 0 + (1-\theta) * [P_{Mol}(t)/[e(t)*P_{USA}(t)]] / [P_{Mol}(t_0)/[e(t_0)*P_{USA}(t_0)]] \quad [2]$$

where t_0 denotes the last quarter of 1993, P_{Mol} is the Moldovan CPI, P_{USA} is the CPI in the USA.

The key parameter of interest here is θ . It provides a measure of the credibility of the National Bank commitment to the leu stability. For example, assume that there are only two sorts of economic agents in Moldova – optimists, which believe that the NBM will keep its

⁹ “The main objective of the National Bank of Moldova is the maintenance of the national currency stability. This objective can be achieved through the implementation of a severe monetary and credit policy and through the implementation of a foreign exchange policy that corresponds to the situation of the market of the Republic of Moldova. In the condition of deterioration of external balance of payments and absence of a durable economic growth, the stability of the Moldovan leu exchange rate is one of the main pillars that contribute to the stability of the national currency and attraction of foreign investments.” - National Bank of Moldova, 1997 Annual Report

promise and pessimists, who believe that the depreciation scenario will come true. Then θ is the share of optimists in the population. Alternatively, θ and $(1-\theta)$ can be understood simply as the probability weights that people assign to the two scenarios.

To illustrate the interpretation of monetization developments in Moldova in terms of public confidence in the national currency, one can calculate exemplary values for θ for each period. What is needed for this, is to assign values to the parameters of the money demand function. The values for a , k and n , were chosen in the following way:

k – real income elasticity of real money demand was assumed to be equal to 1, so that monetization is not influenced by the real growth or shrinking of the economy;

a – constant term was chosen so, that in the situation of the credible exchange rate stability monetization increases to about 37% of GDP – the average value for a country with the income level as in Moldova (see figures 3.1, 3.2 and regression in Table 3.1);

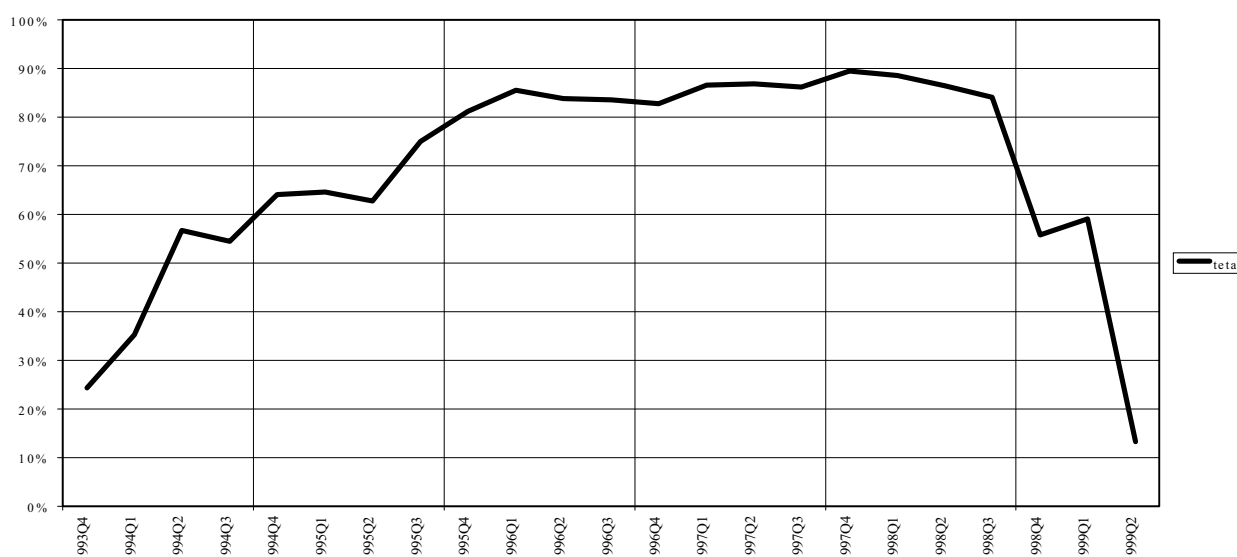
n – elasticity of the money demand with respect to the expected depreciation was chosen so, that in the situation of a perfectly certain 50% depreciation, monetization decreases to 3.7% of GDP, or one-tenth of the ‘stable-exchange-rate’ value.

As can be seen from the above, the choice of the parameters was fairly arbitrary. However, whatever values are chosen, they do not influence the qualitative characteristics of the resulting series of θ values. The series reflects the assumptions of the model:

- Growth of monetization is ascribed to the growth of public confidence in the leu.
- When inflation in Moldova accelerates, the risk increases that the exchange rate would become unstable. If, nevertheless, economic agents do not reduce their holding of leu, this is again ascribed to the growth of public confidence in the leu (and vice versa).

The exemplary time path of θ values calculated with all the above assumptions is presented in Figure 3.5 below.

Figure 3.8. Public confidence in the stability of the leu



Source: own calculations

Interpretation of the monetization developments in Moldova in terms of the model described above is following: Since the currency reform and introduction of the leu, public confidence in its stability was increasing steadily, initially very fast and more slowly beginning with 1996. The peak was reached in the last quarter of 1997. Already in the first quarter of 1998 the confidence began to decrease. After a devaluation in 1998 Q4 it dropped sharply

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and, after a small recovery in the first quarter of 1999, it plummeted again to a level close to zero¹⁰.

Conclusions

Monetization of an economy (ratio of Broad Money to GDP) is an important indicator showing the level of activity and development of the financial sector and public confidence in the banks and in the national currency. Monetization has been shown to be closely linked with the overall level of development of the economy.

After a successful macroeconomic stabilization Moldova underwent a significant re-monetization. As a result, by 1997 the ratio of broad money to GDP, although still low in the world perspective, was one of the highest among post-soviet countries. In 1998 process of demonetization of the economy started again, casting doubts on the depth of the earlier progress. Disturbances caused by the regional crisis aggravated the situation. However, demonetization started much earlier and resulted from structural factors. Money supply factors played only a secondary role.

Monetization was shown to behave in a similar way as other variables connected with the public confidence in the currency: the level of International Reserves of the Central Bank and dollarization of deposits. The reversal of the remonetization trend, as well as the concomitant shift in the other two variables, provided an early warning signal that something was going wrong in the economy. Exchange rate crisis in the fourth quarter of 1998 proved the signals to be right. A close monitoring of all these three variables together could have prevented the Central Bank from leaning against the flow for too long and defending a currency that was increasingly perceived as bound to depreciate.

Monetization developments interpreted in terms of a simple money demand model proposed above allow to draw an inferred time path of public confidence in the stability of the leu. This experiment shows an increasing confidence in the leu since its introduction, an outflow since beginning of 1998 and a dramatic tumbling down since the end of 1998.

Both the results of the developed model and the levels of monetization of the economy and of dollarization of deposits convey a clear message: Currently the confidence of economic agents in the national currency is very low. This is an unfavorable circumstance for the National Bank of Moldova and it should be taken into account in the design of the present monetary policies. In the conditions of such low confidence in the leu any monetary expansion is likely to be reflected especially quickly in the level of exchange rate. Attempts to stabilize the exchange rate are likely to be much more costly than if the confidence were higher.

The model and the earlier analysis concentrate on the issue of confidence and abstract from the underlying reasons of changes in public expectations. The rational grounds for formulation of expectations are broadly twofold. First, it is the speed of development of an efficient, market economy with an export potential. The second crucial factor is the health of the public finances. These factors determine the future pressures on the foreign exchange market and the prospects for currency stability. In addition, irrational, bandwagon expectations or blurred perception of the actual developments can also influence the public expectations.

¹⁰ Admittedly, the validity of model assumptions and the stability of parameters can be questioned after the huge devaluation in 1998 Q4 and after the Central Bank apparently temporarily gave up its policy goal.

4. WEAK BUDGET POLICY?

In Moldova the fiscal-budgetary policy is under the constant attention of the public opinion, this being determined by its importance as the main economic policy instrument, and by the critics coming from power structures, public and international organizations, political movements, and mass media information means. This is of no wonder, the fiscal-budgetary policy being the only policy where interests of different social groups meet together in the most obvious way.

Efficiency Criteria of The Fiscal-Budgetary Policy

To reach a consensus concerning goals, means and results of the fiscal-budgetary policy among the interested social groups is rather difficult, therefore an objective appreciation of this policy should be based on a number of acceptable criteria.

The efficiency of a fiscal-budgetary policy focusing on : (1) *collecting budget revenues*, (2) *honoring budget commitments*, and (3) *management of the budget deficit and state debt*, can be measured by analyzing the result of the public authorities activity in the mentioned above fields.

The state of public finance has a strong influence on the real sector of the economy, *the dynamics of macroeconomic indicators* constituting one of the success (or unsuccessful) criteria for the promoted policy scenarios.

Another descriptive factor of the fiscal-budgetary policy is the *degree of executing the budget related legislative and normative documents*.

Revenues of the Consolidated Budget

Essential Elements Affecting the Tax Collection

- Economic activity is the most important factor that determines tax collection. Most taxes are related to the economic performance. Income tax will generate sources only when the income is actually earned. The indicator of income tax applied on non-juridical entities drops as well, although not to this extent. A general fall in taxation basis is being registered.

The fall of economic activity determines the decrease of sales and of the value added tax, excise taxes, etc. Value added tax, excise taxes, imports are very good indicators of the economic activity level.

- The second important factor that determines tax collection is the fiscal regulation efficiency level, it depends on the professionalism and skills of personnel involved in perceiving taxes, and on the corruption level.
- The legislation is the basic element in tax collection process. Its ability to comprise a rather large taxing basis is essential for a fair distribution of the fiscal burden. The willingness to honor fiscal commitments depends on the tax payer's vision concerning the correctiveness of the fiscal burden attributed to him.

The Evolution of Incomes Collection

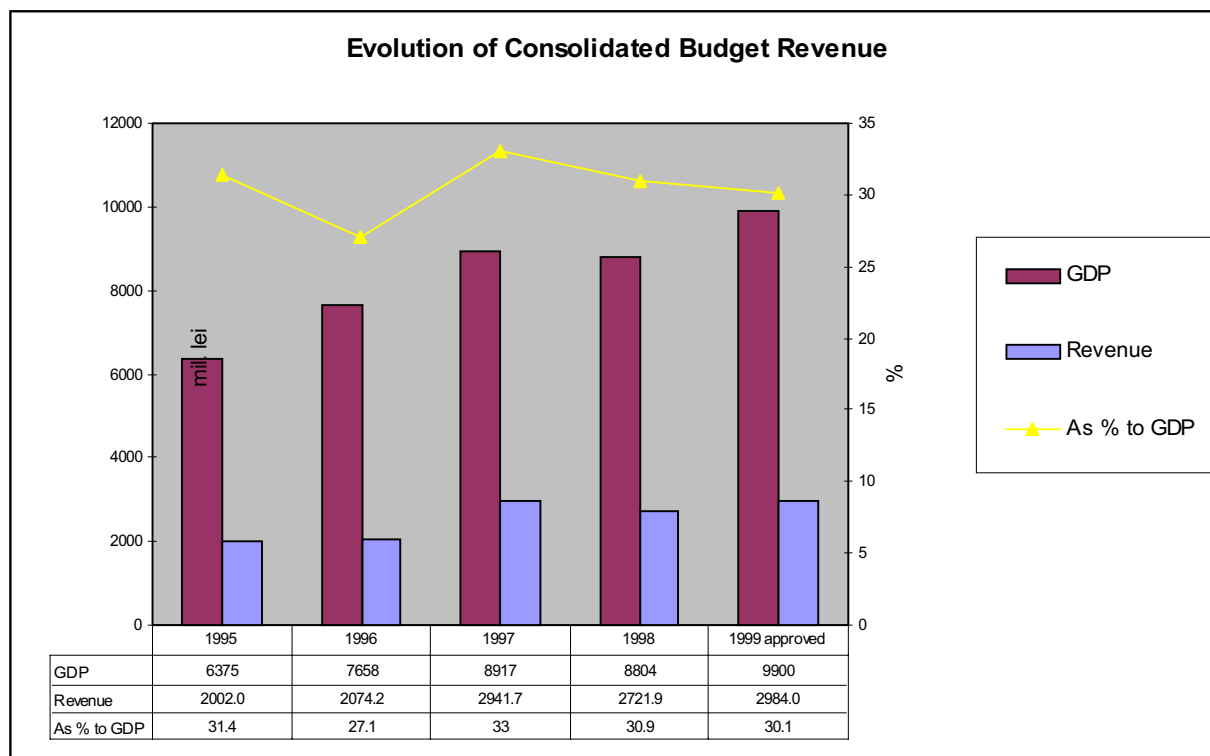
First of all we will analyze the evolution of the consolidated budget *vis-a-vis* the macroeconomic performance, this constituting one of the major problems encountered by Moldova.

4. WEAK BUDGET POLICY?

The growth rate of the gross domestic product in real terms in 1995 was of (-3), in 1996 – (-7), in 1997 – 1.6, and 1998 – (-8.6) percent. In general, when a slowdown in the economic activity is being registered, fiscal revenues should drop, because they tend to be in direct relationship with the economic performance. The correlation between these indicators gives information about the economic activity cycle.

The collection of revenues in the consolidated budget in 1995-1999 was not uniform (Figure 4.1).

Figure 4.1.



Source: Ministry of Economy and Reforms, Ministry of Finance

Two regresses in tax collection are evident – in 1996 and 1998 years, as well as a significant increase registered in the 1997 year. For a better understanding of changes that influenced these evolutions it is necessary to examine descriptive factors of the tax collection level.

The analysis of tax and other financial means collection evolution proves that in the period of 1995-1998 the share of fiscal revenues in the total consolidated budget revenues was maintained at 78-81% level, these collections registering an increase from lei 1619.2m in 1995 to lei 2298.5m in 1997 and lei 2205.9m in 1998 (an increase of approximately 1.4 times). At the same time the share of non-fiscal revenues registered a number of essential changes in the 1997 year, they being characterized by the increased collection of revenues from transactions with capital. (Table 4.1)

Although we have no possibility to estimate with certainty the influence of inflation rate on the incomes growth, it is evident that a part of economic activities (shadow economy) is taxed, especially when performing import-export operations.

Therefore, opportunities to improve the macroeconomic statistics do exist.

Table 4.1. Structure of the Consolidated Budget Revenues in 1995-1999 (in percent)

	1995	1996	1997	1998	1999 approved
Total revenues	100	100	100	100	100
• Fiscal revenues	80.9	81.3	78.2	81.0	76.1
- direct taxes	35.2	34.2	23.1	18.8	18.8
- indirect taxes	40.9	43.6	50.2	59.1	53.9
• Non-fiscal revenues	17.9	16.9	13.6	16.1	14.9
• Revenues from operations with capital	1.2	1.8	8.2	2.9	5.3
• Grants					3.7
Information: the share in the total payments:					
• In cash	74.5	64.8	63.2	64.2	90.4*
• Through mutual compensations	25.5	35.2	36.8	35.8	9.6*
Note: *Based on results of executing the budget on 9 months of 1999 year"					

Source: The Ministry of Finance

The share of direct taxes registers a continuing decrease in the Total Revenues and in Fiscal Revenues, especially with respect to the share of value added tax. In 1996 direct taxes constituted about one third of Total Revenues, and in 1998 – less than a quarter. At the same time the share of indirect taxes registered an increase from 40.9% in 1995 to 59.1% in 1998. During this period value added tax collections, one of the main budget revenues sources, evaluated to 41.3% in 1998 as compared with 28.8% in 1995 in the Total Revenues.

Although the sum of the value added tax was rather satisfactory, it is necessary to present a evolutionary differentiation of collections of value added tax applied on goods made in the country and on imported goods. The value added tax to goods imported in Moldova has registered a significant increase, and to goods produced in the county – a tendency of considerable decrease, especially in 1999 year (Table 4.2). This type of taxes is a rather precise indicator of changes in fiscal policy and reflects the evolution of the economic activity in the country.

Table 4.2. Value Added Tax Collection in 1995-1999 Period (mil. lei)

	1995	1996	1997	1998	1999	
					Approved	Executed
Value added tax total, including:	576.7	613.9	948.9	1124.0	963.1	614.1
- to goods produced in the country	528.0	520.5	787.8	763.8	459.1	223.2
- to imported goods	48.7	93.4	161.1	360.2	504.0	390.9
The Share of value added tax in Total Revenues	28.8	29.6	32.2	41.3	32.2	30.8

Source: The Ministry of Finance

The differentiation between the VAT due to imports and to goods produced in the country is important because it affects the distribution of revenues between the state budget and local budgets. The divergent evolution of its components states a considerable decrease of revenues at the level of local budgets, they receiving transfers only from the value added tax to goods produced in the country. Considering that for some territorial-administrative units revenues from this type of taxes constitute more than 50% of the total own revenues, their dependence on the state budget and the tremendous increase of debts to expenditures can be easily explained.

Indirect taxes refer more to transactions than to the activity that generates the value added tax. Still, indirect taxes such as excise taxes, value added taxes are much easier to collect, because they are applied on visible transactions, while direct taxes such as income tax, land tax,

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and real estate tax are collected (in final form) after all activities that generated them are completed or were estimated. Thus, the regulation of direct taxes is more expensive and depends much on the cooperation of taxpayers when completing honestly the declarations.

An important factor that influences the tax collection level is the use of an adequate mechanism for performing mutual debts compensations between the state and economic agents. The share of these compensations has registered an increase from 25.5% in 1995 to 35.8% in 1998 in the total consolidated budget revenues. Usually, these compensations reach large dimensions by the end of the year. Thus, in the fourth quarter of the 1997 year collections through mutual compensations constituted 52.9% of the total collected revenues during this period, and in the fourth quarter of the 1998 year – 62%.

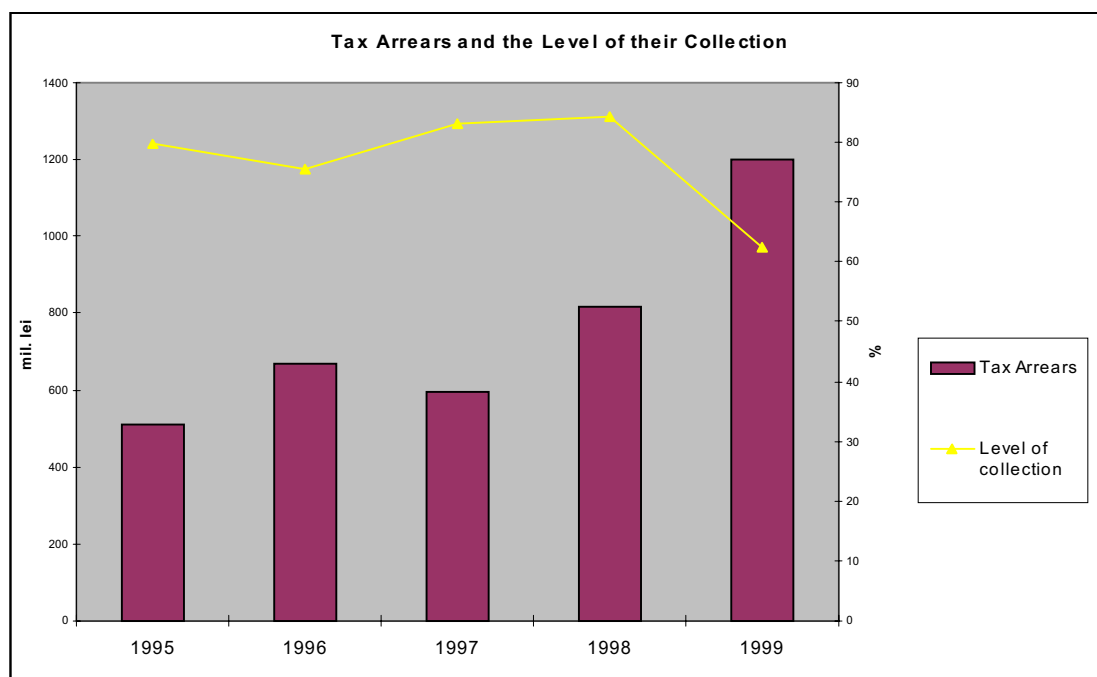
At the same time economic consequences of this payment form were multilateral– from undermining the fiscal basis of the budget for the future periods to extending the dimension of using non-monetary instruments in relations with economic agents, which contributed much to the degradation of the payment system from Moldova.

To your attention, when some restrictions in performing mutual compensations were introduced cash collections registered a considerable increase. When approving the budget for 1999 year a 10% limit of the total revenues for performing payments through mutual compensations was set, it having a positive influence on the budget. Thus, nominal collections of budget revenues paid in cash during 9 months of the 1999 (lei 1800.2m) exceeded the value of annual cash collections registered in 1998 (lei 1746.4m).

The level of calculated payments in budget collection and debts

Payment commitments of taxpayers are not completely honored in the set terms and are added to debts. Debts to budget increased from lei 509.8m in 1995 to lei 917.6m in 1998, maintaining this tendency during the 1999 year (Figure 4.2). These debts constitute about one third of effective collections from the budget revenues.

Figure 4.2.



Source: The Ministry of Finance. For the 1999 year are used data on 9 months

The highest budget calculated payments collection level was obtained in 1997 (83.2%) and in 1998 (84.3%). This index on 9 months of the 1999 constitutes 62.4%.

In the total debts volume the debts share to paying value added tax and excise taxes constitutes more than 50%. From the perspective of national economy branches the biggest debts to budget on all types of taxes registered in 1998 year were debts of enterprises from the agro-industrial sector – 52%, from the processing industry branch – 8%, from the power engineering sector – 3%, from constructions – 2%.

Who collects taxes?

In the last couple of years a change in the importance of state institutions involved in collecting taxes was observed. The share of collections regulated by the State Fiscal Service has diminished, while customs offices increased their contribution to collecting revenues.

According to calculations of the Center for Budgetary and Financial Analysis, revenues collected by fiscal bodies reduced from 79.1% in 1995 year to 56% in 1998 and revenues collected by customs bodies increased respectively from 7.5% to 24%.

A possible explanation of changes in the functional structure of tax collection would be the considerable increase of value added tax applied on imports, it being collected at the customs offices. At the same time increased debts to budget this proving the low level of fiscal regulation.

Honoring Budget Commitments

The dynamics of the consolidated budget expenditures registered essential deviations as well. (Table 4.3)

Table 4.3. Consolidated Budget Expenditures Dynamics in 1995-1999 Period

	1995	1996	1997	1998	1999
Expenditures, total (million lei)	2376.0	2827.0	3608.4	3027.1	3567.0*
Share in the GDP (in percent)	37.3	36.9	40.5	34.4	36.0
Budget cumulative debts (million lei)	552	670.0	560.0	884.0	940.0**
Share in GDP (in percent)	8.7	8.7	6.2	10.0	9.4***

Note: *Approved for 1999 year, considering rectifications made during the year

**Cumulative budget debts as of October 1, 1999

***The share is calculated with respect to the annual forecasted GDP.

Expenditures as part of the gross domestic product were rather high and exerted excessive pressures on the monetary policy (that continued the adherence to the policy aimed at maintaining a relatively low and stable inflation rate), resulting in high interest rates (the interest for state securities were in average of 30%, and in several periods from the 1998 year exceeded 40%).

Pressures on expenditures originate from the following fields:

An important part of budget expenditures – about one third – are made through mutual compensations that represent a method to increase expenditures. Mutual compensations, viewed as a non-monetary transaction, have become a form of fight against the economic shock when the economic growth registers a decrease. As a consequence, the fiscal discipline is neglected. Through it is being maintained the activity of non-efficient enterprises, and the structure and functions of the current expenditures of the public sector remains unchanged.

- The Government has an expensive program for social expenditures. Annually these constitute more than 50% of total budget expenditures. The restructuring of expenditures in

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education and medicine, social assistance was slow and did not contribute to improving the efficiency, reducing energy consumption and labor force use.

Due to big internal and external government debts, expenditures for returning these debts continue to increase reaching the level of 13.9% in the total budget expenditures for the 1998 year with respect to 4.9% in 1995. In the budget approved for 1999 year the share of these expenditures constitutes 26.2%.

Internal and external Government guarantees have defalcated from the budget additional expenditures in the share of 2.4% in 1995 and 1.7% in 1996 and 1997 of the total expenditures and continue to cause debts increase in the future. During 9 months of 1999 were disaffected budgetary means for honoring internal and external guarantees of the total sum of lei 150.8m.

Mechanisms for regulating public expenditures are not elaborated, and to date effective expenditures exceed levels foreseen in the budget, thus being created budget debts in arrears.

Budget expenditures registered a considerable increase in 1997 year – 40.5% of the gross domestic product. In this period were reduced debts of budget financed institutions, especially debts to salaries and from the power engineering sector.

In 1998 budget expenditures diminished in absolute value by 16.1% or by 6.1 percentage points as share in the gross domestic product with respect to indices obtained in 1997. At the same time the budget debts increasing rate was 1.6 times or lei 324m, their cumulative level being one of the highest in the last years – 10% with respect to the GDP.

Consolidated budget expenditures for 1999 year were set at lei 3,100 million, being recently rectified to lei 3,567 million (an increase of lei 467m). On October 1, 1999 were financed lei 2275.5m, constituting 63.8% of annual budget stipulations, during the year being accumulated new debts of the total value of lei 56m.

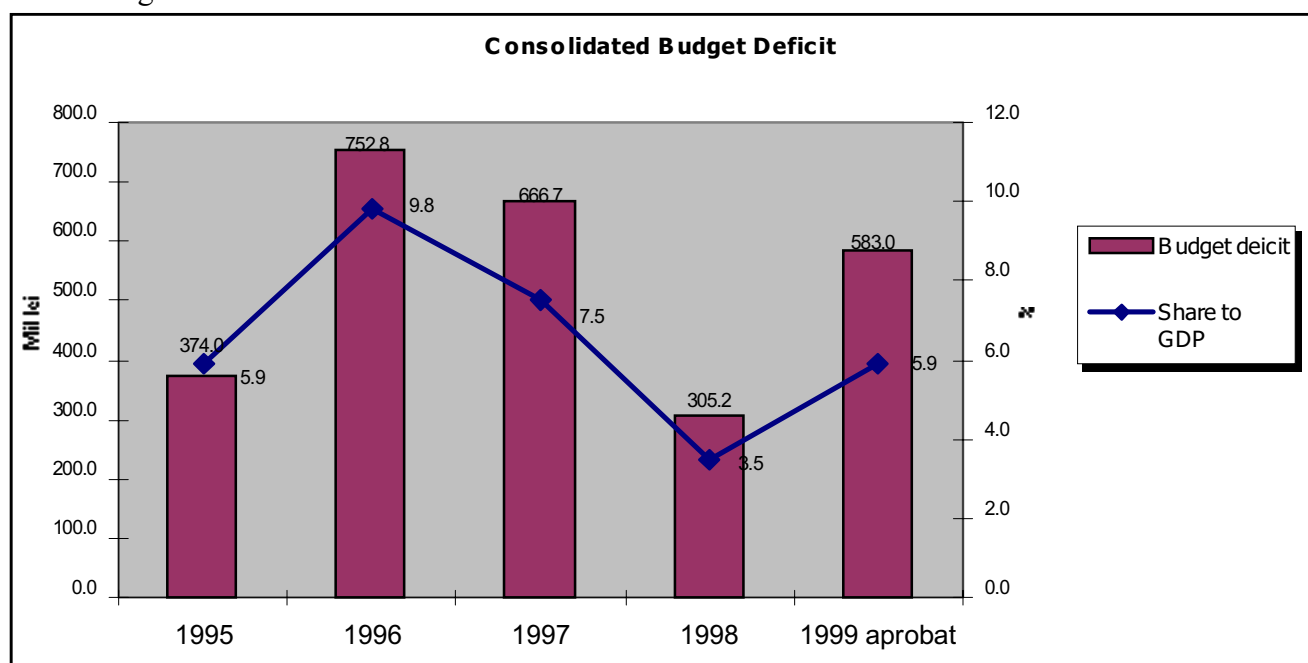
The Budget Deficit and the State Debt

The basic term of budget deficit is determined as a difference between the total sum of government expenditures and collected revenues. If expenditures exceed revenues, the government finances the deficit by issuing internal and/or external debt.

In a country where the economy is „monitored” by financial markets and by the civil society, governments are stimulated to reduce the deficit, because its existence might stop the flow of foreign and internal investments. When private economic agents are worried about an economy led by the deficit, interest rates increase, thus leading to increasing costs of financing it.

During the last years Moldova was facing the problem of high budget deficit (Figure 4.4). The highest budget deficit level was registered in 1996 and 1997, respectively 9.8 and 7.5% with respect to the gross domestic product, the lowest level – 3.5% – in 1998 year.

Figure 4.3.



Source: The Ministry of Finance

In Figure 4.3 is presented the deficit of cash operations, data used by the Ministry of Finance, it does not showing the real situation in the budget. The process of accumulating budget debts continues, and this with a lack of a mechanism aimed at ensuring the respect of budget limits marks the inclination to accumulating public debts in order to cover the budget deficit. As a consequence, the level of Moldova's debts continues to increase.

Internal and external debts of the state (regulated by the Government), their annual increase and share of expenditures for honoring the state debt are presented in Table 4.4.

Table 4.4. Evolution of the State Debt In 1995-1999 Period

Indicator	1995	1996	1997	1998	1999 approved
Internal debt, <i>million lei</i>	476.7	736.8	983.9	1571.9	2000.0
Annual increase (with respect to the precedent year), <i>million lei</i>	206.4	260.1	247.1	588.0	428.1
External debt, <i>million US\$</i>	435.9	508.9	709.1	719.6	810.0
Annual increase (with respect to the precedent year), <i>million US\$</i>	118.3	73.0	200.2	10.5	90.4
Expenditures for honoring state debts, <i>million lei</i>	116.0	163.2	376.5	421.2	933.8
Share of expenditures for debts servicing in the GDP, %	1.8	2.1	4.2	4.8	9.4

Source: The Ministry of Finance

External state debt registered a significant increase in 1996-1997, when state securities were issued on the external capital market and international organizations (IMF and WB) granted credits to Moldova, considering the positive appreciation of the economic-financial situation given by the international rating companies. The use of a part of these means for supporting the Balance of Payments created the capacity to finance additional budget expenditures and conditioned the increase of the budget deficit.

For 1998-1999 period is characteristic the necessity to honor external commitments, that due to lack of external financing imposed the use of internal sources and especially of credits granted to the Government by the National Bank of Moldova. As a consequence, in 1998 year the internal debt increased with respect to the 1995 year by more than 3 times, being expected a dramatic increase in the 1999 year.

The use of crediting resources of the National Bank of Moldova as financing sources for the budget deficit, including honoring and returning external commitments of the Government, exert excessive pressures on the monetary policy, affecting the level of exchange rate of the national currency and the inflation rate, thus diminishing the crediting capacity of the real sector of economy. When maintaining under control the inflation is strictly necessary to reduce expenditures for services provided to the budget and of the public debts taking into consideration the limited capacity of the Government to register revenues from inflation.

When costs of internal and external credits tend to grow, one of the main tasks is to attract sums from privatization and direct investments (flows that do not generate debts) so that to create premises for Moldova to honor the payment of interest on external debts for the future without accumulating considerable debts in case the external credibility drops, or to go through a liquidity crisis.

A recently appeared problem that can grow in dimension, is allowing the creation of deficit by the Social Fund and local budgets. Attraction of commercial credits can create a debts crisis, its consequences being reflected in the state budget. Thus the policy aimed at attracting credits of any level must be regulated by the Government.

Features of the Macroeconomic Dynamics

In a market economy the macroeconomic policy should be based on the prognosis of government revenues and expenditures, it depending greatly on the technical prognosis of the gross domestic product. Economic estimations used to calculate this index must be clear and supported by the economic theory and empirical evidence.

The experience of the past years proves that preliminary estimations of the gross domestic product were constantly over-evaluated: in 1996 – by 2.5%, in 1997 – by 24.4%, and in 1998- by 12.8% (calculations in nominal terms). Avoiding to accept the reality leads to unjustified revenues over-evaluation. With respect to expenditures the Government is forced to create bigger debts in cash and in the form of arrears, because planned expenditures exceed collected fiscal revenues. Debts influence the governmental deficit that is the most important statistical index in the macroeconomic policy.

The execution degree of budget related legislative and normative documents

The execution degree of budget related legislation and normative documents in the analyzed period proves the statement that indices approved through the annual budget law are not always based on real forecast. Introducing new amendments to the budget law during the year became a rule (in 1997 being introduced 9 amendments, and in 1998 - 5).

In the table that follows are shown approved budget indices and the real evolutionary execution of the consolidated budget (1995-1999 period). The execution degrees of budget differs in different periods. Common for each year is that the budgets were not executed with respect to the approved indices, and with the rectified indices as well, although amendments to the law were introduced by the end of the year.

Table 4.5. The Execution Degree of the Approved Budget Indices In 1995-1999 Period

	1995	1996	1997	1998	1999
Approved Budget (million lei):					
Revenues	1790.4	2370.0	2620.6	2950.0	2900.0
Expenditures	2090.4	2720.0	2950.6	3300.0	3100.0
Deficit	300.0	350.0	330.0	350.0	200.0
Rectified Budget (million lei):					
Revenues	2214.5	2438.1	2654.6	2880.1	2984.0
Expenditures	2597.7	2867.6	3254.6	3180.1	3567.0
Deficit	383.2	429.5	600.0	300.0	583.0
Real Budget Execution (million lei):					
Revenues	2002.0	2074.2	2941.7	2721.9	1993.7*
Expenditures	2376.0	2827.0	3608.4	3027.1	2275.5*
Deficit	374.0	752.8	666.7	305.2	281.8*
Budget Execution Degree (executed against the rectified), in % :					
Revenues	90.4	85.1	110.8	94.5	66.8*
Expenditures	91.5	98.6	110.9	95.2	63.8*
Deficit	97.6	175.3	111.1	101.7	48.3*
To your information: Budget arrears created during each period as compared with the precedent year (million lei)					
Debts to budget	253.6	160.1	-74.3	222.0	383.4*
Budget Arrears	152.2	118	-110	324.0	56.0*

Note: * Data on 1999 year regarding budget execution and budget arrears are presented in accordance with the situation registered as of October 1.

Source: The Ministry of Finance

The fiscal-budgetary policy promoted in Moldova during 1995-1999 cannot be considered sufficient enough. When the fiscal-budgetary policy was the most loyal, it caused the increase of budget debts and debts of economic agents to the budget (more specific for the 1996 and 1998 years). The use of a more harsh policy (in 1997 year) allowed to register a slow-down in debts increase and even a reduction of their absolute level in real terms.

These conclusions are made on the basis of results obtained when executing the budget, and not on policies declared in the process of budget elaboration and adoption. At the same time it is important to monitor the influence of factors and the influence of these results on other economic variables.

The 1999 year – new chances, new failures

The 1999 fiscal year began in difficult political and economic circumstances. Although since the beginning of the year the state fiscal-budgetary policy was pretty much clear (the budget law was already adopted) there were many questions regarding the reality of the budget.

The financial crisis from the region generated premises for devaluating budget allocations foreseen in the budget. In a half of a year most budget -financed institutions exhausted their annual allocations to some expenditures chapters, as it was foreseen at the beginning of the year.

Nevertheless, the partial liquidation of the financial crisis effects by implementing urgent measures aimed at improving the economic situation (that foresaw a tightened budget as well) allowed rectify the state budget. A special role had to have external financial means, Moldova having rather good relations with international financial organizations at that time.

In case of Moldova a rather important role in the efficiency of the fiscal-budgetary policy belongs to the political will. An attempt to prove this will was made during the 1999 year. This is being manifested through the following:

- The fiscal-budgetary policy can be efficient only when all agents activate according to *universal laws for everyone, with no exceptions*. Such exceptions during the last couple of years were: crediting from the budget, offering state guarantees, mutual compensations, fiscal holidays, forgiving compulsory payments for certain agents. This year it was reduced to minimum.
- The efficiency of the fiscal-budgetary policy depends much on the *capacity to protect the customs territory* of the state. From political and economic considerations customs territory of Moldova during these years remained "broken" from the Eastern side of the country. With the creation of fiscal posts the flow of imported goods in Moldova without paying the respective tariff reduced. The solution of the problem is pure economic, although it is not rather efficient.
- *Mutual compensations* that transformed in a profitable business during the last years were stopped to a certain extent. In April 1999 the Regulation regarding mutual compensations was elaborated and approved. During the first 9 months of the year about 9.5% of budget revenues constituted revenues through mutual compensations (in 1998 year this figure constituting over 35%). To mention that recently the Constitutional Court decided to announce illegal this Regulation...
- *State (internal and external) debt regulation*, is an element that determines the fiscal-budgetary policy and its efficiency. 1999 year is a peak for the country at the chapter of returning the external debt. Certain successes have been achieved, the main event of the year being considered the transaction for re-purchasing securities issued for Russian Gazprom company of the total value of US\$ 140m.

The policy aimed at ensuring equity, transparency, the compulsory character of the fiscal-budgetary policy was supported to a great extent by the international financial organizations. Re-setting relations with the IMF, and the negotiation and receiving new credits for structural reforms from the World Bank proved their credibility concerning the economic policy, and especially concerning the fiscal-budgetary policy.

The decrease of the external trade could seriously affect the budgetary system of the state. On the other side, measures aimed at consolidating the financial discipline (reducing mutual compensations and instituting fiscal posts) and, to a certain extent, devaluation of the Moldovan leu in the first quarter, contributed to maintaining the budgetary system in a functional regime.

Collections to the budget, especially in the second and third quarters, exceeded levels registered in the precedent year.

Monthly Collections in the Consolidated Budget (million lei)

	1999	1998
January	105.3	174
February	148.4	118.2
March	201.7	226.3
April	198.4	148.4
May	269.3	163
June	260.6	189.6
July	248.2	190.1
August	215.4	213.2
September	346.3	169.7
TOTAL on 9 months	1993.6	1592.5

Monthly Collections in the Social Fund In Financial Means (million lei)

	1999	1998
January	25.15	25.7
February	26.54	25.9
March	27.06	33.7
April	41.9	35.09
May	36.36	28.7
June	34.44	27.87
July	42.95	28.83
August	45.34	34.67
September	47.67	28.89
TOTAL on 9 months	327.41	269.35

Honoring commitments with increased responsibility has become a permanent priority. Statistical data show a positive evolution in diminishing debts to paying salary from the state budget, and during the last two months – at the level of local budgets as well. Debts to old age persons register a decrease. Starting with September debts to salaries and pensions are paid regularly, from the state budget being paid a part of these debts. It is important that in this process are used current collections of the budget system and not credits from the banking system.

The Evolution of Debts to Budget Financed Employees and Old Age Persons (million lei)

	1/01	1/02	1/03	1/04	1/05	1/06	1/07	1/08	1/09	1/10
State Budget	67	98	94	94	99	97	103	85	66	52
Local Budgets	106	136	149	158	166	151	160	160	159	142
To pensions	259.3	275.5	303.2	339.0	338.7	354.2	371.8	378.5	371.9	349.1

During September and October the tendency of decreasing interest rates on the State Treasury Bills market was maintained. Only during two weeks the interest rate registered a double fall up to the level of 14.21%. This phenomenon is a consequence of the policy aimed at limiting the issuance of state bills till the level when the state can repurchase them from circulation. For the following periods this moment can be crucial especially when determining the interest rates at crediting the national economy, making the banking system more open for crediting economic agents at the same time.

4. WEAK BUDGET POLICY?

Although expectations were more pessimist the leu stability in the June-September period proved its credibility for the economic policy promoted in the country.

During the year were registered several chances to improve the situation in the country's economy, as well as a number of failures.

The main failure is related to restructuring the power-engineering sector, the largest generator of public financial means losses and generator of social pressures. Intentions to restructure this sector caused anxiety in the respective sector, but had no political support in the society. Here we shall stress once more that the greatest part of mutual compensations were passing through this sector, credits under state guarantee being granted, for this sector being characteristic the most sophisticated state acquisitions system.

The consolidation of the financial discipline leaves to be desired. Measures that are taken are superficial. Fiscal, customs and financial control bodies remain to be corrupted and involved in different schemas for public funds embezzlements. The motivation of their work is not sufficient, this making the entire activity of the respective structure inefficient.

The governmental crisis from the beginning of November swiped away all chances to improve the economic situation, planned before the end of the year. The elaboration of the budget for 2000 year is being tergiversated, there is no clarity in the economic policy for the next coming year.

All these create uncertainties for economic agents, external creditors, potential investors, the society in general.

The de-blocking of the governmental crisis is a premise for marking a clear fiscal-budget policy that could contribute to the solution of social-economic problems. It is important to continue, and not to deny everything was done, better or worse during the 1999 year.

It is important to re-gain the credibility of international financial organizations and of the potential investors through negotiations.

5. PROPERTY REFORM: HOPES AND DISAPPOINTMENTS

The 90's decade was characterized by massive privatizations in Europe and Latin America countries. Economic theory suggests, that private enterprises are more efficient than the state run ones, having higher factor productivity, producing competitive goods. Profitability, measured as net income to sales, as well as output, sales, dividends –all are higher, while leverage decreases. The major objective of corporate management is maximization of shareholders' wealth, expressed in increased value of equity – capital gains and increased dividends. Pressure factors on the management, which force them to strive for superior profitability, are: threat of bankruptcy, threat of job losses as a result of underperformance, threat of hostile takeovers.

Several types of privatization are known: restoration, direct sales and public offers, management and employees buyouts. The Washington Consensus recommended the voucher privatization through investment funds as the best policy approach to the property reform in transition economies.

The stages of privatization

In 1990 the Parliament of the Republic of Moldova approved the concept, and in 1991 the Law on Privatization. The voucher model (National Patrimony Bonds) was adopted, a "fast privatization track" being accepted. Particularities of the Moldovan model were: nominal bond, distributed exclusively to Moldovan citizens, not subject to trade; nominal value being determined according to individual's employment record plus the equivalent of 5 years for everyone, including the children; the bond entitled its bearers to a share of public property. In March 1993 the Mass Privatization Program, along with other standard acts, which constituted the framework of the privatization process, were adopted. In order to ensure the equity of distribution, 50% shares of processing enterprises were transferred to the main suppliers of raw agricultural products. The employees were allowed to purchase at preferable prices up to 20% of their enterprises' shares. TACIS and USAID technical assistance programs helped during the creation of the privatization framework. Price Waterhouse Company assisted all the stages of privatization and helped with the establishment of the securities market.

15 shares subscription auctions were organized, where citizens and Privatization Investment Funds could participate. 1142 enterprises were privatized. Out of 3,067,164 filed applications, 471,690 had been presented directly to collection centers, 2,585,549 had been presented through investment funds of trust companies, 9,925 applications had been declared invalid. Circa 1093 small enterprises were privatized through 94 traditional auctions and 11 open offerings. According to the Department of Privatization and Administration of State Property (DPASP) data 93% processing units, including 78% - winemaking, 82% - light industry, 96% - commercial units, 95% - social services enterprises, and all sugar processing, canning, dairy products, repairing enterprises have been privatized in such a manner. 90% of issued bonds have been utilized in this process.

On May 5th 1995 the State Privatization Program for 1995-1996 was adopted. The program stipulated: extension of privatization, including the assets of state owned enterprises, rented spaces, adjacent territories; elaboration of new mechanisms for privatization – individual projects, public offerings; diversification of means of payment; homologation of shareholders' rights. Almost 100 laws and standard acts were elaborated, 115 centers for bonds collection have been instituted; licenses for 53 investment funds and fiduciary companies have been issued.

5. PROPERTY REFORM: HOPES AND DISAPPOINTMENTS

The Program stipulated the privatization of 1553 units, the number of which increased to 2065 as a result of de-monopolization of some enterprises. These objects were included in 4 lists: 1306 – for privatization bonds, 190 – for cash, 457 – unique enterprises and individual projects, 99 – premises under construction. 93.9% enterprises included in the 1st list have been privatized for bonds. Only 9 unfinished constructions were sold for 632 thousand lei.

Privatization Program for 1997-1998 was adopted on July 25, 1997 and its implementation started on September 11. The following have been declared as major objective the modernization of State's role in the economy: withdrawal from productive activities; modification of regulatory functions in order to create a favorable environment for

entrepreneurship; development

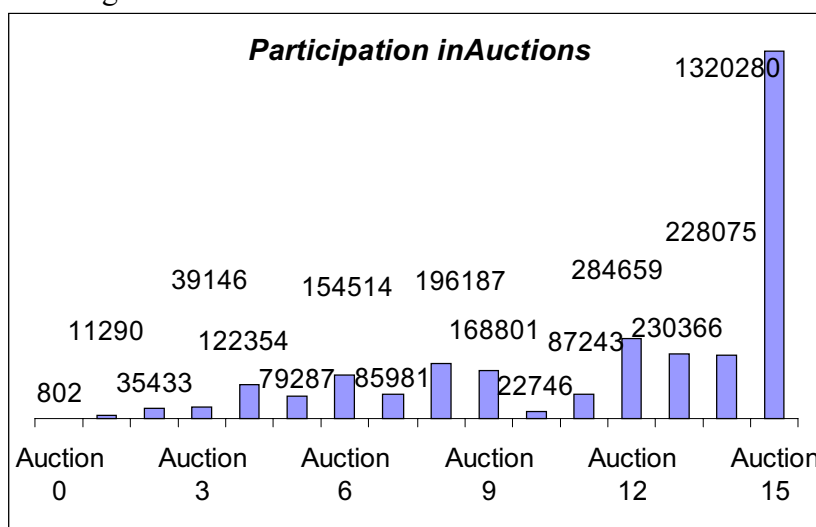
of the capital market, initiation of the cash privatization; concentration of efforts for solving social problems – education, medicine. The objects to be privatized were included in 3 annexes, which specified – 554 typical items, 28 enterprises that required individual privatization projects, approved by the Parliament, and 130 unfinished premises. Also, the shares of 797 previously privatized joint stock companies were supposed to be sold through the Stock Exchange. The nominal value of those stocks, still held by the State, was estimated at 373.8 million lei.

The implementation of the Program was delayed by eight months, 148 enterprises, 9 unfinished premises, and 15 unique companies being privatized during the specified period. Therefore, on December 12, 1998 the program was prolonged for the years 1999-2000. In order to attract a large number of investors some modifications were introduced: the payment of 75% of the cost could be spread out over a period of 5 years, which allowed for additional investment into the productive potential at the yearly stages of reconstruction; sales of illiquid state enterprises at the symbolic price of 1 leu, with the imposed obligation on the buyer to pay off the arrears; sales of equity through the Stock Exchange, which would lead to the formation of the equilibrium price and strengthening the infrastructure of the capital market.

JSC “Bălțeanca“, acquired by Steilmann Group for DM 1,750,000, was the first enterprise to bring in real money as a result of privatization. Other companies sold to foreign investors in 1998 were “Ciment”, “Agro-Petrol”, „Farmaco”. Beside the acquisition price, investors additionally were committed to invest in the production process and assumed a part of the debt of privatized enterprises to the State budget and to suppliers. Overall, in 1998 87 million lei, DM 82 million, US\$ 57.7 million were invested.

A unique, interesting experiment is under way at the JSC “Ionel”. The State share of 64%, estimated at 1.8 million lei, is being bought out by employees (circa 2000 people) and management over a three-year period. 225 thousand lei have been already paid, another 1.6 million lei were invested in production. “Ionel” is a light industry enterprise, producing clothes and outwear based on contracts with Italy, Canada, Russia. The net income in 1998 constituted 2.3 million lei. Over the first semester of 1999, the output of “Ionel” increased by 51% compared to the same period of 1998.

Figure 5.1



Source: National Commission on Securities Market

The Moldovan-Irish Company Listmore Investment was declared as winner of the tender for the privatization of "MoldCarton". They offered 11 million lei also promising to invest US\$ 10 million and to cover arrears of 36 million lei. At the moment the enterprise functions at 15-20% capacity mainly because of the lack of raw materials. There are contracts signed with German firms for the delivery of paper waste. *In December the Economic Court of Moldova canceled the transaction.*

According to DPASP data in the first 9 months of 1999, 80 out of 128 objects have been sold for 18.3 million lei. For one unfinished premise were received 395 thousand lei. 300 rented premises were privatized for a total of 26.4 million lei. 783 adjacent territories with an area of 208 hectares were sold for 13.6 million lei. At 22 investment tenders 17 objects, valuing 78 million lei, were privatized. Besides, 390 million lei were committed for investment.

Following the decision of selling state shares through the Stock Exchange, in 1997 equity in 198 enterprises has been sold for 2.6 million lei. In 1998 shares of 104 enterprises were sold for 5 million lei. In 1999 the remaining shares in 53 companies were sold for 13 million lei. Till September 1st, 1999 the shares of 322 out of 855 enterprises were sold for a total of 20.9 million lei. The biggest transaction was registered with 28% shares of the largest brewing Company "Vitanta-Intravest". DPASP expects to sell in 1999 the shares of another 69 companies through the Stock Exchange. One could argue, that commercial enterprises face the highest demand, and the price is determined according to the financial state of the company and to the amount of shares put up for sale.

The social implications of privatization were barely discussed in the Republic of Moldova. Although the long-run effects of privatization are supposed to be positive, in the short run severe social costs are observed. First of all, *fringe benefits* were reduced – industrial employees used to have some of the following benefits: kinder-gardens, general and vocational schools, sport and cultural premises, summer camps, specialized clinics and hospitals, subsidized food and transportation. The worst decline was observed in capital spending – housing building and maintenance, social infrastructure development. The amount of fringe benefits differed by localities and by sector of industry, benefits being correlated with the size of companies. The benefits, received by Center subordinated enterprises, were by one third higher than the ones received by state employees. Rural population was receiving the least benefits, motivation being their ability to grow their own food. The average fringe benefits by sectors in 1991 in Moldova were estimated at 20-25% of the wage fund. In the conditions, when limitations on the size of the salary were imposed, non-salary benefits served as a bargaining tool in attracting the most qualified labor. The Western companies are also offering some benefits in form of pension funds payments, life and medical insurances.

The official unemployment rate in Moldova is 2.1%, but the surveys, organized by the WB reveal a 9.4% rate, while independent experts estimate it at 12-13%. Common practices in Moldova are un-paid, forced leaves. A partial explanation of the hidden unemployment in Moldova is the existence of the above fringe benefits. The management of enterprises did not want to fire the employees, because they could maintain soft budget constraints – subsidies, guaranteed credits, fiscal arrears.

It is commonly accepted, that in order to increase competitiveness, companies should be absolved from the responsibility of providing social services. The public and private sectors have different, distinct sets of problems. The state, however, can contract private firms to fulfill certain tasks, but the attribution and financing of these tasks should be carried out in a transparent way, which is impossible to achieve in the conditions of existing unfounded governmental mandates, while both sides can escape the hard budget constraints¹¹.

¹¹ Sewell, David, *Shifting Responsibility as Enterprises Privatize in Belarus*, WB Policy Research Working Paper 1719.

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Although social service objects are considered as assets, they constitute a burden for the enterprises. Their administration distracts management's attention from the achievement of their direct obligations – implementation of an efficient production process. One should complete the transfer of social objects from balance of enterprises to the balance of local budgets. Unfortunately the set of acts, defining the functions and responsibilities of local administrations was adopted only in 1999.

Other short-run negative social implications mentioned in the literature are: increase in unemployment; diminished salaries; worsening of working conditions; rise in the consumer goods prices¹². State enterprises are likely to employ extra labor force, pay excessive salaries and have low factor

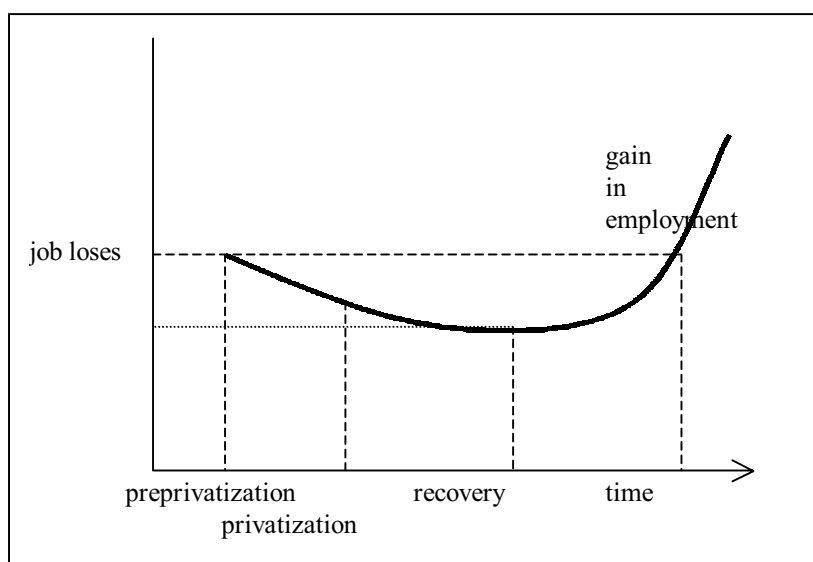
productivity. Studies on privatization suggest that employment tends to evolve on a U-curve. If the company is viable over in time as a result of investment, followed by enhanced production, it would increase operation, and, as a result, the initial employment level will be attained. Also, increased efficiency, resulted from privatization, should bring about lower prices. The fact, that former state companies were heavily subsidized, resulted in higher price for goods, and particularly, for consumer goods. CPI in 1999 constituted 4890 (1990=1), while the salary index was only 880. The real salary in 1998 constituted only 17% of the 1990 level. Distribution of income also deteriorated, the Gini coefficient evolving from 0.29 to 0.44 over the given period of time.

The private sector also tends to pay higher wages. Current data from the Department of Statistics and Sociological Analysis (DSSA) as of November 1st, 1999 support that argument in the construction, education, medicine, and real estate sectors. The agricultural, industry, trade data show a different picture, but lower salaries in the private sector are explained by underreporting of income levels. The salaries in the mixed property sector (without the participation of foreign capital) are higher in virtually all the areas, except fishing and trade.

Aspects of privatization

The previous Parliament deferred inadmissibly the land reform, which occurred in 2 stages. Initially, each family was entitled to at least 0.3 ha, with additional 0.1 ha for each member of the family (starting with fifth person). During the second stage, launched after the adoption of the Land Code on January 1st, 1992, the outside-built over areas started being distributed. In February 1995 the allocation of equivalent land plots has been stopped as a result of the adoption of the Law on Modification and Completion of the Land Code. On January 25th, 1996

Figure 3.2



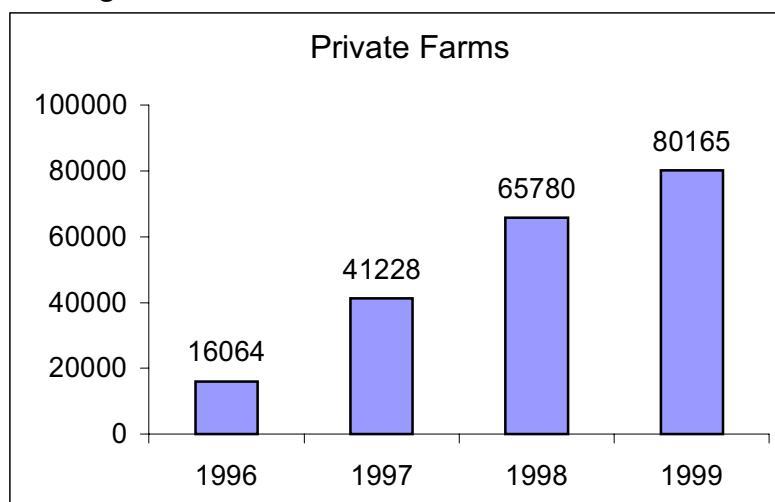
Source: Stanjeev Gupta, Christian Schiller, and Henry Ma, *Privatization, Social Impact and Social Safety Nets*, IMF Working Paper 1999

¹² Stanjeev Gupta, Christian Schiller, and Henry Ma, *Privatization, Social Impact and Social Safety Nets*, IMF Working Paper 1999.

the Constitutional Court declared those modifications unconstitutional, which accelerated the distribution of land.

The pilot-project „Pământ” – “Land”, which stipulated the privatization and reorganization of agricultural enterprises, was launched in 1997 and permitted the privatization of 72 enterprises. The National Program of Privatization and Reorganization of Agricultural Enterprises “Pământ” took off afterwards. Private companies, licensed by the Cadastre, Land Resources and Geodesy Agency, were involved in the project. By January 1st, 1999 contracts with 650 enterprises were signed. By April 1st, 1999,

Figure 5.3.



Source: DPASP

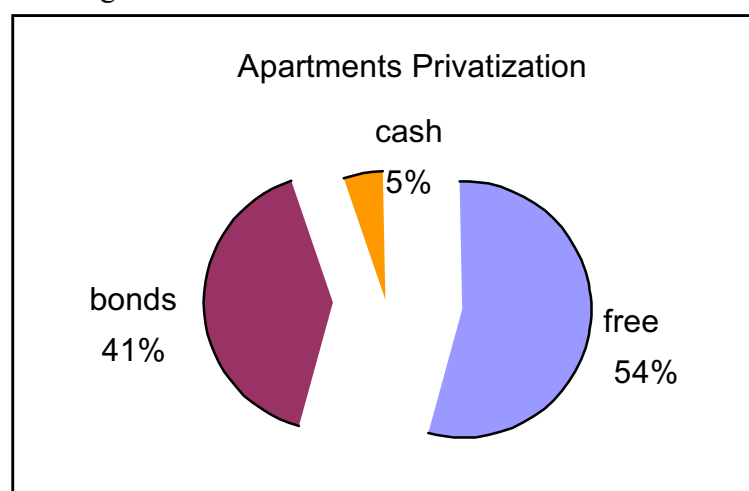
95.8% of citizens entitled to equivalent land plots, received the titles certifying their rights. 36 thousand people were put in possession of land. By the 3rd trimester of 1999 circa 1200 former agricultural enterprises have been restructured. Up to date 874 enterprises applied for the participation in the “Pământ” project, 778 contracts being already fulfilled. Over 160 thousand citizen already received land titles.

For equity proposes, caused by the difference in land quality, each person received several plots, even within the enterprises reformed by “Pământ” program. In the end a family could end up having more than 4 plots, bearing additional production costs. The international practice shows, that only large-scale agricultural enterprises can be profitable. A more lucrative method of distribution could be in conferring a coefficient, correlated with the size of the plot, quality, and proximity to the settlement, and distribution of land according to that coefficient.

Adoption of the Law on Restructuring Agricultural Enterprises under Privatization, which specifies the postponement and cancellation of debts of agricultural enterprises, is a measure that will help create the owners’ class in the countryside. The cumulative debt of agricultural enterprises as of January 1st, 1999 amounted to 2 billion lei.

One of the few aspects, positively appreciated by the population is the privatization of state housing. A family could obtain for free their apartment if the combined length of service constituted 35 years as of March 10th, 1993. One had to pay 25% of the apartment’s cost if the length of service was between 30-35 years, and 50% if the length of service was between 25-30 years.

Figure 5.4.



Source: Department of Privatization and Administration of State Property

Patrimonial Bonds could have been used for the privatization of housing. As of January 1st, 1999, 89.4% of the state apartments have been privatized (225600). During January-September 1999 another 5270 (4900 in the city of Chişinău) apartments have been privatized. As a result, 490 associations of residents were formed. The budget received 26.3 million lei. The situation with dormitories is more difficult. One could privatize them only if 60% of residents would have agreed on that. The dormitories of educational institutions were not subject to privatization. A manifestation of social inequity was the decision, prohibiting rural inhabitants to privatize their housing for bonds.

Privatization of apartments helped to create the real estate market, which is essential for economic development. It was estimated, that a quarter of unemployment in transition economies is caused by labor force immobility, resulting from the lack of housing. The real estate investment is considered to be profitable almost everywhere. Some residents, which are unable to pay the rising utility bills, would like to exchange their apartments for smaller ones. After the 1998 crisis, according to the "Lara" real estate agency, the dollar prices for apartments in Chişinău City were falling by 10% monthly, reaching a slight stabilization in the summer of 1999. The prices of 2-3 room flats are converging to the 1-room ones, so the investment turned out to be not as profitable as expected.

The problem of the Moldovan patrimony on the territory of other States has not been completely solved. As of January 1st, 1999 the list of objects situated on the territory of Ukraine was not updated. In April 1998 a draft of a treaty between Ukraine and Moldova for the mutual recognition of rights and regulation of property relations upon the objects of one side located on other side's territory was elaborated. There have been also elaborated modifications to the inter-Governmental Treaty from August 11th, 1994. The enterprises in Russia have been restructured and transformed into JSC. The wine bottling enterprises of Moldova, located in Russia have been priced in rubles, which contributed to their increased attractiveness after the ruble devaluation in summer-fall of 1998. But this diminished the amount of revenues, which Moldovan budget was supposed to receive. Besides, the funds for the acquired enterprises haven't been transferred yet.

The problem of adjacent territories was a determinant for the process of privatization. The Cadastre Agency started functioning only in 1998, a wide geodesic map of Moldova has not been elaborated yet. The normative prices for land, which was too high, ranging from 10 thousand to 1 million lei, was utilized. The completion of transaction with "Lafarge" was delayed for some time, because the normative price of the land was higher than the price, the firm paid for SA "Ciment". The Department of Supervision within the Prosecutor's General Office reported, that, as a result inactivity of local governments, for 1500 plots sold (with the surface of 333,000 ha) instead of 30 million lei were received 12 million only. Lately fewer enterprises are purchasing adjacent plots because of hard financial conditions.

Perspectives for privatization

The pace of privatization in Moldova is heavily influenced by politics, the latest developments being a concluding example. In accordance to the World Bank's SAC-2 agreement, the Parliament adopted in the first reading the individual projects for the privatization of 5 wine making enterprises, 6 tobacco fermentation plants and of the JSC "Tutun-CTC". In October 1999 the Parliament halted the privatization of these units. The arguments of the right-wing political forces were based on the corruption in the Government, which is unable to carry on an efficient privatization. The forces from the left argued that the companies are still profitable, the budget receiving revenues at the moment. However the financial reports show, that "Aroma", "Struguraş", "Vismos" companies, as well as the fermentation plants from Ciadâr-Lunga, Făleşti had registered losses. The dynamics of sales

present a catastrophe, caused partially by the fall of demand in Eastern markets. The underlying reason for the delay in privatization is group interests. There were set up small firms near the main enterprises, through which the profits, by transfer pricing are siphoned off.

The MoldTelecom Company has a long privatization history. On September 11th, 1995 the Government adopted a decision to reorganize and privatize this enterprise. The first plan, designed in July 1996, asked the strategic partner to pay and commit US\$ 120 million. The winner of the tender – OTE Telecom offered US\$ 46.4 million, and the Government canceled the tender.

On October 14th, 1998 the individual privatization Plan for the State Company MoldTelecom was adopted. By January 5th 1999 MoldTelecom became a JSC. The first draft of the project offered a 5-years exclusive license to the buyer, but the Constitutional Court considered the monopolistic provision as being anti-constitutional. The winner is required to increase the density of phone lines to 25 per 100 inhabitants. Tariffs will be fixed, with a possibility to adjust them every May to the inflation rate. On May 31st, 1999 a contract with Price Waterhouse Coopers was signed for the accomplishing of an audit for MoldTelecom. The Government seeks an Investment Bank for the management of the MoldTelecom Privatization. For that purpose presentations in the UK and in the US have been organized.

The winner of the tender will automatically receive a license to render mobile telephony services on the territory of Moldova. The French Company VOXTEL monopolized the Moldovan market. The Moldavian-Turkish company MoldCell purchased recently a license for mobile telephony, but because the process was not transparent enough, the Prosecutor's Office declared the transaction illegal.

One cannot delay any further the privatization of such a strategic sector. Modern technologies – mobile telephony, Internet, Internet Telephony, will lead to a drop in the demand on the international market. The price evolution on the world market is evident. Due to the technological revolution, telecommunications may not be considered natural monopolies any longer. Econometrical analysis suggests that increased competition as a result of privatization is positively correlated with increased number of phone lines per capita, increased number of public phones, a superior connection capacity, reduction of tariffs for local calls. But exclusive licenses delay the benefits of privatization; therefore one should note the Government decision to institute an Independent Regulatory Agency. Besides, the practice reveals that privatization without a regulatory agency leads only to an increase in the number of public phones¹³.

On August 2nd, 1999, the Government announced an open International Tender for the privatization of electric distribution companies. In April Parliament adopted the Law on the Debt Restructuring in the Energy Sector. Credit Comerciale de France was selected as consultant for the privatization of energy sector. The privatization of distribution network should be accomplished by the end of 1999, of the generating enterprises – by March 2000. According to the Law on Energy Sector Privatization, the State assumes the historical debts, which amounted to 1.5 billion lei by mid-1999, therefore, the amount received is expected at least to cover a part of the sum. The major cause of privatization of that vital sector is the technical deterioration of the distribution network, major investment being needed. Permanent energy disconnections, caused by insufficient supply of fuel, resulted from arrears, affect the production process. Also, it generates an additional problem – stealing of hi-voltage cables for base metals.

¹³ Wallsten, Scott J., "An empirical analysis of competition, privatization, and regulation in Africa and Latin America", May 1999

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The 100% state share is supposed to be transferred into private hands in three stages, based on the geographical principle. The winning company is supposed to have experience in the field and to have sales of at least US\$ 100 million per year. 5 Companies out of 8 withdrew their offers as a result of political instability in Moldova, caused by Government's resignation. The Russian Company RAO UES lost its license, and the Ukrainian Company Luganskoblenergo's offer was rejected because it did not comply with the requirements. The only company left in the contest is the Spanish "Union Finosa", which offered for: "RED-Chisinau" SA - US\$ 20,200,000 plus the promise to invest US\$ 42.9 million over a 5-year period, "RED-Nord" SA - US\$ 15,300,000, "RED-Sud" SA - US\$ 5,100,000 and investment in the amount of US\$ 13,268,000. The winning company is also supposed to additionally invest US\$ 32.9 million into the re-launch of the distribution network.

A hard decision is expected – the acceptance of the offer or the organization of a new tender in the condition when the foreign financing is ceased for a uncertain period, and Fitch IBCA agency downgraded Moldova's rating from "B" to "B-".

Other enterprises that could be privatized by the end of the year are:

The largest cosmetics producer SA „Viorica”, the deadline for offers being set for October 25, 1999. The market share of the company is 30%, and continuously growing as the leu depreciates. State share is 96.12%, the remaining belonging to individual shareholders.

November 30, 1999 was fixed as deadline for the tender for „Zorile” privatization – the largest foot-ware producer in Moldova, which accounts for a 20% domestic market share. Statutory capital is estimated at 19.2 million lei, the State holding 60% shares, the employees – 20% shares. „Zorile” has its own distribution network in Moldova. This fall the enterprise launched a product line, with 170 new models.

The Parliament accepted in the first reading the Project of privatization of the Company „Tirex-Petrol”. In November the NCSM issued the approval for the reorganization of the enterprise into 3 components: „Tirex-Petrol” with a statutory capital of 41 million lei, „Zidpetrocon” with a statutory capital of 2.55 million lei, and „Combustibil” with a statutory capital of 33 million lei. The Moldovan side is negotiating with the Romanian Company CONEL about the transfer of 51% shares of „Tirex-Petrol” for the outstanding debt for energy to the Romanian partner.

The process of preparation of documents for the privatization process is extremely slow, some investors being discouraged by these procedures. A similar case happened with „Moldova TUR”, the largest travel-agency in Moldova, which is considered to be privatized now. The company experiences at the moment some difficulties, caused by a 3-time drop in tourist's flow compared to the last year.

One should consider the privatization of the State monopoly – Moldovan Rail Roads Company. It operates at loses at the moment, while several transporting and freight companies are flourishing around it.

By the end of December the DPASP expects to privatize another 16 enterprises.

Corporate governance

It was argued, that *voucher* privatization was the only possible way of privatization in Moldova, the main arguments being social equity, political support from the population, and lack of local finances for the carrying out of privatization. The problems, common for a mass privatization program, are linked to the disperse structure of shareholders, partially solved by the cartelisation of shareholders through investment funds and trust companies.

A brief review of other privatization models suggests, that from the point of view of morality and public confidence in the intentions to pursue the property rights principles, the *restitution* is the best solution. But this process is selective and may take too long, delaying privatization. *Direct sales* to investors bring new technologies and knowledge; result in higher privatization proceeds in the conditions of an underdeveloped capital market. The investor, which values the enterprise the most, will guarantee its most efficient use. But the wide population strata consider them as inequitable. Another drawbacks of the method are shortage of local capital, lack of interest from the foreign investors, insufficiency of information, considerable expenses on advertising and supervision of the process. *Management-employees buy-outs* are one of the preferred methods, and one of the fastest ones. The costs of this method are weak corporate governance and efficiency losses. The enterprises tend to keep high employment levels and wages above the market ones, underinvesting in production. They also lack the skills and abilities for restructuring. Employees have to gain the most, while the large masses do not benefit from such privatization. It was estimated, that outside dominated firms outperform the insider dominated ones, but the most prosperous are *de novo* – green field companies¹⁴. To support that, department of industrial policy data show, that while during the first semester of 1999 the industrial output had fallen by 25.2% on average, SA "Farmaco" increased its output by 21%, SA "Moldagrotehnica" by 42%, SA "Ionel" by 51%, SA "Floare-Carpet" by 8%. It was observed that food processing and wine-making enterprises are the fastest to restructure. During the same period the output of sugar-beet processing plants increased by 61%, of meat producing enterprises by 26%.

It was formulated the idea of rapid privatization, which will not allow the old nomenclature to regain control, therefore the creation of investment funds, which will carry on the restructuring process, was seen as imminent. The Privatization Investment Funds (PIFs) were created in Moldova according to the President's decree. They constituted a hybrid between mutual funds and holding companies, having several restrictions imposed on them. Overall they concentrated 70% of the value of all the Bonds emitted to population. Individuals, who invested their bonds into fiduciary companies, become shareholders of the enterprises, were the fiduciary company acted as an intermediary, while the individuals who invested in PIFs, become shareholders of the fund. The investment funds, which received the shares of enterprises in return for the Bonds they collected, are considered one-man holders, which entitles them to dividends and to the right to participate in the corporate governance. The income of investment funds is proportionally linked to the performance of enterprises, which influences the dividends paid by the funds.

Aggregate assets of PIFs and trust companies accounted for 1,148 million lei (US\$ 225 million, 98% of total value of the securities) their portfolios including the shares of major Moldovan perspective companies. As of January 1, 1999, the book value of investment funds' assets constituted 864 million lei, the estimated market value being 827 million lei. Statutory capital was 622 million lei. But the assets owned by the funds did not have a real market quotation – "junk shares".

¹⁴ Oleh Havrylyshyn, Donald McGettigan, *Privatization in Transition Countries: A Sampling of Literature*, IMF working Paper, January 1999.

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Some experts argue that the funds did not have the incentives, power, expertise, and capital to carry on the restructuring of enterprises¹⁵. The lack of incentives was primary determined by restrictions, imposed on the shares, held by a fund in one particular enterprise, at 25%, which determined the creation of twin funds as Exiton-Bon, Exiton-Inverst. Even when the fund is committing time and efforts to the restructuring of a company, the benefits will be captured by the remaining shareholders. If the fund holds 50-60% of the enterprise's shares, the free rider problem emerges. Besides, the remuneration of managers is limited by a fixed amount, a fraction of the assets they administrate (5%), and is not directly linked to performance. Even if, as a result of good management team efforts, the assets of the fund would grow considerably, the remuneration could increase only by the share stipulated in the law. Having a spread structure of shareholders, the funds' management does not face any credible threats, in order to increase their performance. Therefore, they find it more lucrative the shares trade operations, transfer pricing, non-transparent transactions. In 1998, 29 investment funds declared revenues (or losses) from transactions with securities. In order to optimize the portfolio structure, they engage in SWAPs. The aggregate revenues from dividends of investment funds for the first 9-months of 1998 accounted for 2,529,100 lei, while the revenues from transactions with shares amounted to 10,424,600 lei – 70% of all revenues.

If several funds decide to join their effort and to control a particular company, they cannot succeed, unless they are totally committed to it and have a unity of views. However, if a company is heavily indebted and close to be liquidated, the control passes to creditors. Therefore, the shareholders do not have enough power to continue the restructuring. The funds also lack the expertise in pursuing the restructuring process. CEEC experience showed, that foreign experts are usually lawyers, accountants, financial analysts, but had little experience in management, industry or technical expertise. The shares have been accumulated in non-cash transactions, but at the initial stage the funds spent vast amounts of money on organization, salaries, and advertisement. Now the founders are trying to earn return on their investment the minor shareholders remaining without the long-promised dividends. Aggregate spending of the investment funds in the first 9 months of 1999 constituted 6,925 thousand lei, while the spending for managers' remuneration amounted to 4,579 thousand lei. This happened when revenues from dividends accounted for 1,928 thousand lei, while the financial results from sales of assets revenues from sales of assets comprised 11,999 thousand lei. The social and political pressure is increasing, the citizens feeling that the "national patrimony" is slipping away to that new financial caste.

The Law on Joint Stock Companies ended the era of administrative control, opening a new era, of corporate governance. Also the investigations reveal, that enterprises controlled by strategic investors are more efficient than the ones controlled by institutional investors, investment funds, which bear large shares (over 25%) of enterprises, and could significantly influence the activity of JSCs in different legal ways, mainly through corporate governance. They are more organized and have more expertise than ordinary shareholders. They boosted the economic activity and investment of several enterprises, promoted new, competent managers. The management staff of enterprises, which found a common language with the investment funds, continues their activity for the benefit of both sides¹⁶. The representatives of IF are members of administrative teams at virtually half of the enterprises, but sometimes they are acting like bystanders, or engage in non-partner relations with the management of the companies. The role of the State representatives at the partially State-owned enterprises is the active participation in the management process, striving for benefits and transfer of dividends to the budget. But the representatives are not always up to the task because of lack of expertise in

¹⁵ David Ellerman, *Voucher privatization with Investment Funds: An Institutional Analysis*, The World Bank.

¹⁶ Sergiu Certan, *Fondurile de investiții în Moldova. Structura caracteristică generală. Masă rotundă : Piețele de capital în Republica Moldova, iunie 1999.*

managing such enterprises, lack of responsibility for the taken decisions, lack of proper remuneration. In 1998 dividends of 4.5 million lei were transferred to the State budget (0.9 million more than in 1997). However, the managers of some enterprises cannot accept the idea, that someone is actually the owner of the company, and is willing to engage in restructuring. They would prefer the existence of atomized shareholders, unable to exercise control.

The performance of investment funds was heavily influenced by the overall economic situation. The managers of the investment funds consider the lack of cash, excessive cost of services on the capital markets, extreme dissemination of shares, and burden of arrears as being the major problems in the activities of investment funds. There are recommendations to create holding companies, based on the current investment funds. The experience also shows, that closed-end structures do not have enough incentives to struggle for efficiency and maximization of their portfolios' values. This structure allows inefficient management to stay in the market without a threat of job loss, therefore all the companies, which employ attracted funds, should be open-end structures.

The solution of the principal-agent problem is crucial for Moldova. It appeared as the shareholders are not admitted to the administration of enterprises' patrimony process, the managers considering themselves as big bosses, profiting from undefined relationships with the shareholders, the local administration, with other manufacturers. As the shares of investment fund are distributed to a large mass of people, and enterprises' managers act as agents for the funds, the principal-agent problem is even more acute.

Several obvious mistakes appeared at the stage of creation and design of their regulatory framework. There are some problems with the organization of general meetings, with the completion and registration of shareholders' lists, with proper informing of shareholders. NCSM discovered several law violations in the activity of IFs and holding companies. Not everyone received their titles; the mechanisms of collaboration with the shareholders of initiation of general meetings are not defined yet. Privatization and transformation into JSC was a new task for managers and for the employees. Also the JSC passed the privatization process, some of them did not register their shares. Some of them had already sold the shares to outsiders. The procedures with the NCSM are widely unknown, therefore the organization of new shares issuances, necessary for the attraction of new capital, are not very often. Several enterprises, which attempted to register new issuances, accumulated insufficient funds, and some issues had been canceled, because not even a single share was sold. All the 299 additional issuances in 1998 were closed ones. As a result of reorganization of JSC, which attempted the increase of their statutory capital, 2000 enterprises, which did not managed to accumulate sufficient funds, are subject to liquidation.

The dividends received for 1998 accounted for 3.396 million lei, the net income being 8.553 million lei. The dividends paid by only six investment funds to their shareholders constituted 4.5 million lei. According to NCSM data the situation in 1996-97 was similar. In 1996 the dividends received by the investment funds amounted to 2 million lei, while their total spending was 4.6 million lei.

Aggregate financial results of investment funds in 1998 show a net income of 2,841,233 lei, which constitutes a 0.3% own capital profitability, 15 funds declaring losses. The legislative framework of privatization was quite liberal, allowing for consolidation of property and access to the secondary market. In order to optimize their portfolios, the investment funds engaged in share trading and SWAP operations. Trust companies registered aggregate losses of 154,413 lei, "Mobiastrest S.R.L." being the only trust company with a positive financial result.

The role of investment funds in the launch of the capital market is also exaggerated, because there were no massive flows of capital from savings into investment— the shares were distributed for free. Foreign investors are looking for productive assets, and are not particularly

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interested in shares; therefore investment funds had little impact on foreign investment. Foreign investors in Moldova are more interested in the establishing joint-capital enterprises than in privatization.

Privatization contributed to a continuous modification of property relationships, according to DPASP, and to the modification of the structure of the national economy through transparent and accessible mechanisms. Privatization has brought in foreign investors for the privatization of strategic companies, created conditions for the post-privatization functioning – financial recovery of enterprises, implementation of modern management, financial analysis and marketing techniques, new production lines, national accounting system and conditions were created for the privatization and restructuring in agriculture, for the establishment of start-up firms.

However not everything can be viewed in such a positive way. Initially, one intended to privatize property worth 10 billion rubles, circa 2/3 of the industrial patrimony. The Bonds were issued in the same amount. Some of the most valuable assets were excluded from the privatization process (through “spontaneous” privatization, which preceded the official schemes, or through elimination of some enterprises from the lists). “Privatization became a *fire sale* to which only the selected few were admitted”¹⁷. This created a misbalance between the value of Bonds and the value of patrimony. One could feel that already during the third bonds auction.

In the early 90s many enterprises started functioning on lease-contracts basis. The Accounting Court discovered over 120 violations of the process of transformation of those companies in JSCs. The lease product was overvalued, sometimes estimated at a higher value than the enterprise itself. Some documents were counterfeited – the year of enterprise creation, the exclusion of some assets during the estimation of enterprises’ value, erroneous indexation of funds to the inflation rate. The employees contributed to the statutory capital, so the share of the state was deliberately diminished. The contribution of new partners was sometimes overestimated. Assets were sold by managers at symbolic prices – the cars, fridges, office furniture. All that diminished enterprises’ attractiveness for foreign and domestic investors. In order to obtain the lowest possible price, one practiced price fixing techniques, the potential buyers were not informed about the auctions or were prevented their participation.

Inexistence of a serious legislative basis became a serious barrier. Although the Privatization Program took off in 1994, the errors occurred in other transition countries were not taken into account. The legal framework, which would define the property right is not perfect, the Law on Collateral and the Law on Bankruptcy have been just recently adopted, the Civil Code is not adapted to the realities of market economy.

One of the fundamental errors of the privatization process was the existence of an unique scheme, with small modifications, without the specification of strategic companies. The pace of reform was severely hampered by the opposition of enterprises’ management, which could have been avoided by employment guarantees or stock offers. Inclusion of social objects into the cost of the company sometimes artificially overvalued the statutory capital.

The rights of minor shareholders are practically ignored in Moldova. Major shareholders of some enterprises opted for the division of the company into several smaller ones, they acquiring the most valuable assets (downtown buildings or office spaces, for example). One admitted to the investment tenders the affiliates of some well-known firms, which were not

¹⁷ Vito Tanzi, *Transition and the Changing Role of Government*, Finance and Development, IMF, June 1999, 36(2)

serious partners by themselves. One failed to supervise the strict fulfillment of obligations assumed by the investors, the assets bought from the state being sold to a third party.

Lack of transparency on the capital market deepened the social inequity. Brokers all over the country for a tiny price collected a large amount of shares received by population during the early stages of privatization. An existence of stock quotations at the Stock Exchange would have prevented such an outcome. The NCSM decision to limit the over-the-counter transactions will eliminate some deficiencies and will lead to a single price creation mechanism.

During the late privatization processes several mistakes were also committed. The fiscal inspectorates sequestered the assets of selective indebted enterprises with ulterior sales of the confiscated patrimony, diminishing the attractiveness of the company. Recent evolutions show, that some perspective small-scale enterprises (mills, oil-mills) are confiscated for their debts to the State budget and then sold through auctions, where the “close” persons are invited.

One should carefully reexamine the banks’ privatization process, where the share of the state was underestimated in virtually all the cases. The history of often ownership changes in the Savings Bank, with its ulterior “nationalization”, is quite suspicious. The banking sector was severely affected by the overall performance of the economy, a huge stock of non-performing credits was accumulated, some of them issued under implicit state guarantees.

Serious impediments to privatization are arrears to the budget and to suppliers. Virtually all the enterprises have accumulated historical debts. Government decision to sell enterprises for the symbolic price of 1 leu will not contribute to a boost in privatization. It is imminent to reschedule those arrears, or in the case of debts to the budget, to consider their cancellation.

The purchasing power of local investors is extremely small. It was estimated, that local finances could cover only 25% of the value included in the privatization programs. A large share of output is produced in the shadow economy. It is observed a slight increase of lei-priced objects privatization due to leu devaluation. The latest capital inflows, according to NCSM, are coming from the offshore zones.

The results of privatization should be assessed not only from the viewpoint of the amount of disseminated state property, but it should be estimated the extent of development of the real private property, of the opportunities created for the functioning of entrepreneurs. As of mid-1999, private sector accounted for circa 60% of the economy and employed 66% of the labor force. The mixed property sector employs 8% of the labor force. The chosen privatization model had to and actually did solve the problem of transfer of property from the state, but could result in the creation of “social property”, when every citizen owns a tiny share of property, but is unable to influence its utilization. „Voucher privatization with investment funds is a *de facto* ‘industrial policy’ of real sector decapitalization in favor of short term rent-seeking by fund managers through financial sinecures and lucrative side deals”¹⁸.

Moldova couldn’t avoid all the problems faced by the ECEC, but in some cases it performed even worse. A possible explanation is seen in the fact, that CIS countries were more integrated in their input-output markets. Foreign trade was done through a Central network; therefore the managers did not have serious incentives for foreign marketing or quality control¹⁹.

Privatization alone, without the creation of market institutions, of a legal and judicial framework, which would lead to a reduction in corruption, does not lead to immediate results. One thought that macroeconomic stability – low inflation, price and trade liberalization, and enforcement of hard budget constraints will be a sufficient incentive for the

¹⁸ David Ellerman, *Voucher privatization with Investment Funds: An Institutional Analysis*, The World Bank.

¹⁹ Simeon Djankov, *Ownership Structure and Enterprise Restructuring in Six Newly Independent States*.

enterprises to restructure. But these measures distracted the attention from a favorable climate for Greenfield enterprises. International financial institutions should be partly responsible for the unsatisfactory results of privatization, as they pursued the governments to privatize rapidly and extensively, under the general assumption that private property will be sufficient for the enhanced performance of enterprises.

Macroeconomic stability is vital for the prosperity of the private sector. Inflation pushes up the wages and the interest rates, resulting in higher operational costs. Exchange rate volatility causes the uncertainty of foreign trade. Companies, subject to hard budget constraints, are more aggressive in collecting the arrears, are switching from quantitative to profitability goals. Competitive markets, and first of all a labor market, are vital for the diversification of production and services, for improved quality.

One did not take into account the secondary – fiscal impact of privatization, estimated as the difference between privatization proceeds and the present value of revenues obtained as dividends from the state controlled enterprises. One should have also accounted for capital transfers, credits, subventions, but also for increased budget spending for social protection.

The State failed to implement the policies, meant to alleviate the social impact of privatization: creation of temporary jobs, of agencies assisting in job search, training institutions, introduction of targeted subventions to the most vulnerable.

Some would call for a re-nationalization of the patrimony, and for a new, more equitable privatization. Good performance of some privatized firms is being explained by the fact, that better enterprises were privatized in the first place (cherry-picking).

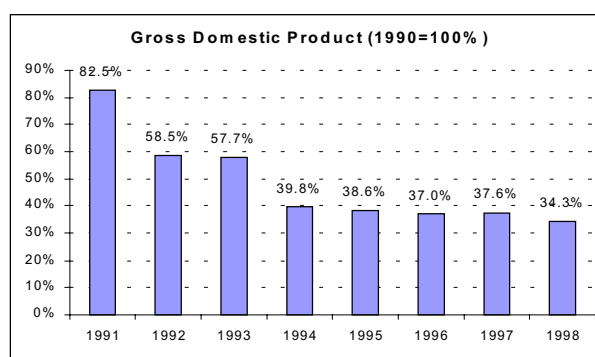
This is not an alternative. One should account for the past mistakes in the process of further privatization, and to elaborate more transparent mechanisms, and performance criteria for the already privatized firms. The solution of property problems in the best interest of owners will result in enhanced efficiency, the State having a unique role in the protection of the large mass of shareholders.

6. REAL SECTOR DEVELOPMENT: TACTICS WITHOUT A STRATEGY

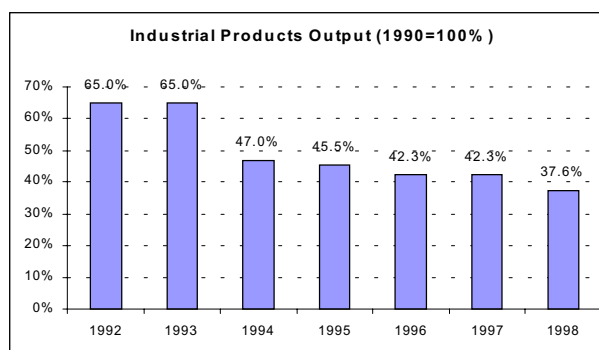
Indicators and problems. At the beginning of the 90s, especially in the period of “struggle” for macro-stabilization, the real sector was placed on the second plan. The disintegration of economic relationships, the decline in demand for goods and services, the liberalization of business activity, prices and foreign trade, the competition of the foreign producers, all these “attacked” the real sector and first of all the industry.

There was no state strategy for industry. The majority of enterprises was “self-rescuing”. “The concept of new industrial policy of the Republic of Moldova to year 2000” has been finally ratified by the Government in October 1996.

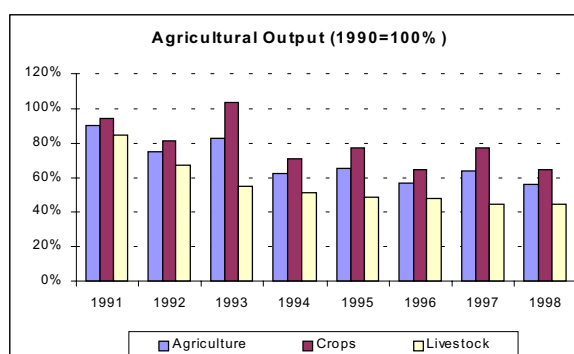
The 90s in Moldova were described as a slump in GDP and in public welfare. Comparing to 1990, GDP accounted for 34 % in 1998, agricultural production – 55.9%, and industrial production – 37.6%. In dynamics of GDP downward trend should be mentioned three important stages.



The first stage (years 1990-1992) was characterized by the disintegration of the single USSR market, the lack of legal basis for the market, galloping inflation, and as a result – the rapid fall of circulating assets of enterprises, the rise in the price of power resources and an increase of energy costs (expenses) in the structure of production costs. Between 1990-1992, GDP decreased with 41.5%, the agricultural production - with 24.9%, and industrial production – with 35.0%.



Between 1993-1994, in Moldova took place the liberalization of prices and foreign trade. The goods of Moldovan producers confronted the tough competitiveness of foreign producers, on internal as well as on the traditional markets of Russia and other FSU countries. Moldovan producers were not able to hold out against the competition, since the hyperinflation deprived businesses of financial resources required for their restructuring. Comparing to 1990, the index of industrial products accounted for 47%, and agricultural – 62.5%.

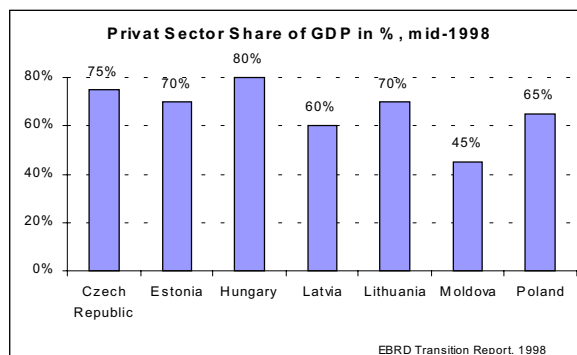


In the absence of industrial strategies and transparent legislation, the managers of the enterprises tried to transfer the administrated assets to some private, controlled by them, entities. As a consequence, the enterprises didn't restructure, and the debts were hiking.

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Such a situation didn't threaten the managers of the enterprises with any problems due to the lack of legal mechanism on bankruptcy and lack of development of corporate governance system.

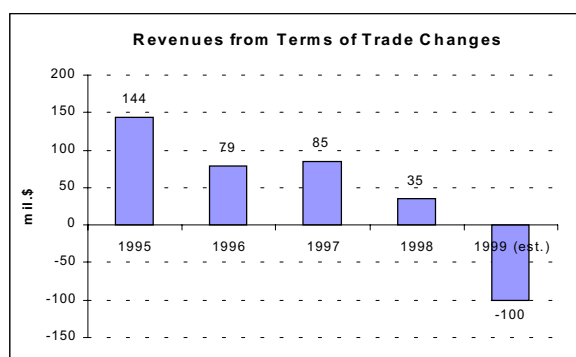
Since the state didn't practically have the control over its property, the created situation was possible to positively change only through privatization. By the way, the weight of private sector in GDP was and continues to be smaller in Moldova comparing to other countries with economic transition, where the economic growth already started.



Starting with 1995, the real sector enters into a period of depression. In order to get out of this situation, it was necessary to create a favorable investment climate for small and medium enterprises, for investments and restructuring, based on a transparent legislation that regulates the activity of enterprises. Unfortunately, the quality of legislation, the environment for institutionalization and the application of Courts' decisions in Moldova continue to be at a very low level. Until the mid of 1998 in Moldova took place the mixed privatization (for vouchers and money), after which from the state property started to be privatized the most important and appealing enterprises. These have slowed down the creation of a favorable investment climate in the country.

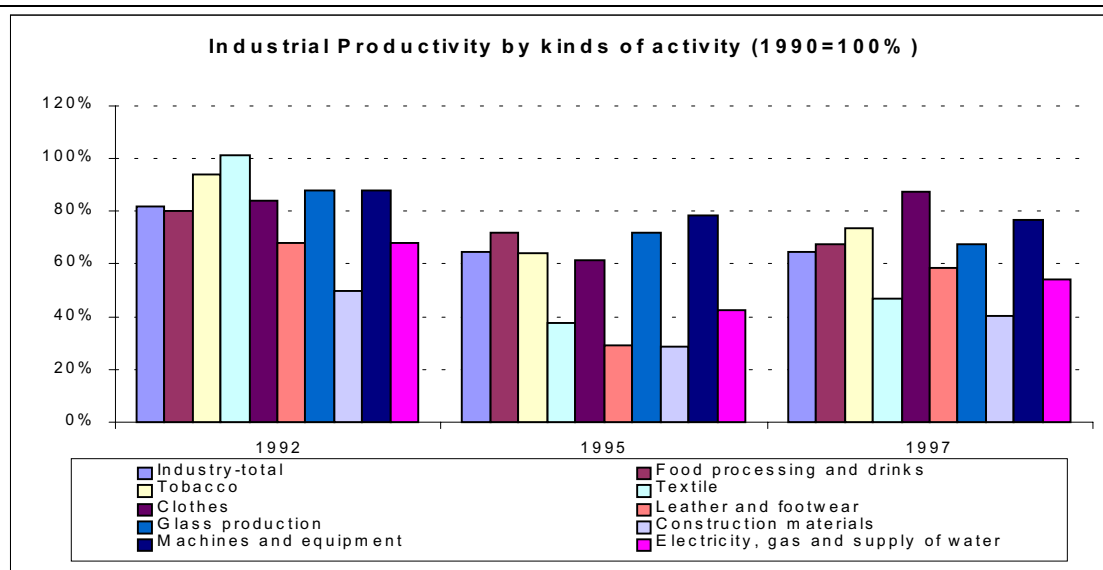
The slight growth that was registered in 1997 was lately annihilated by the financial crisis from Russia – this showing a significant dependency of Moldovan producers of Russian market (import of energy resources, sales of products).

The regional crisis had worsened the macroeconomic environment for the Moldovan producers: depreciation of national currency, the rise of inflation, cut backs of exports. After the introduction of local currency, 1999 was the first year that registered substantial losses (around US\$100m) that were a consequence of the changes of commercial conditions.



The lack of state strategy on promotion of Moldovan products on new markets, was conditioned by personal and collective interests of Moldovan managers for the FSU markets. Scarcity of financial resources for the restructuring of enterprises didn't let the raise of competitiveness rates of these enterprises – productivity of work in industry decreased and lowered to 82% in 1992 comparing to 1990, and continuing to lower in 1995 – to up to 65%. A little better is the situation in light industry: thus, between 1995-1997 the productivity of work in textile enterprises increased by 26%, in clothing industry – by 42%, in leather and footwear enterprises the productivity of work doubled.

A significant decline agricultural output took place before 1994. Starting by 1994 agricultural production stabilized (regardless to unfavorable climatic conditions).



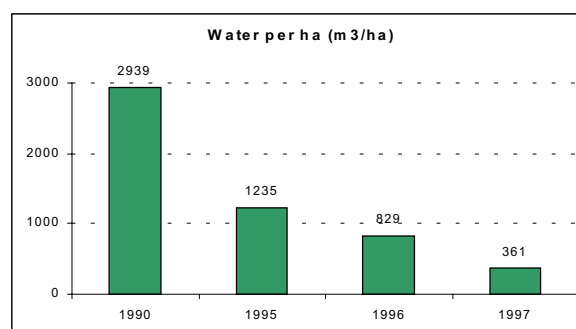
Reasons for the decline of agricultural output are:

- scarcity of financial resources;
- high price of credits (interest rates for credits);
- incapability to renovate the machinery park;
- undefined property rights for the agricultural enterprises;
- the old system of supply and selling of agricultural products was destroyed, and the new one was not created yet;
- inefficient and not transparent system of subsidies in agriculture;
- decline of purchasing power of the population, diminishing demand for agricultural production;
- loss of sales market after the breakdown of SU market;
- lack of competitiveness of production of food enterprises caused a decline in food processing industry, and reduced the demand for agricultural raw materials;
- presence of different kinds of barriers (tariff and non tariff based ones) for Moldovan agro-industrial production on the markets of other countries.

A decline of the agricultural production in 1994-1998 in comparison with 1981-1990 took place for goods which are not tradable at commodity exchange (vegetables, fruits, and grapes), a biggest part of their production had to be directed for final consumption and processing inside the country. As a rule, the production of these goods needs essential material and financial expenditures. For goods which could be sold at commodity exchange (grains and sunflower seeds) the decline of production was not essential.

The volume of investments in agriculture and food industry declined essentially during last years, because the unfavorable investment climate in the country. On the base of total investments there were modernized only 18% of the fixed assets of the agro-industrial sector, the remaining 82% are out of date.

Irrigation is vitally important for the agriculture of Moldova due to low level of precipitation in much of the country and its variability. The situation of the watering means is worse. As a result of a "wild" actions in the agrarian sector during the first half of '90th it became incomplete: from 2.5 thou of sprinkling-machine today are able to work in reality not more 500. In comparison with 1990 consumption of

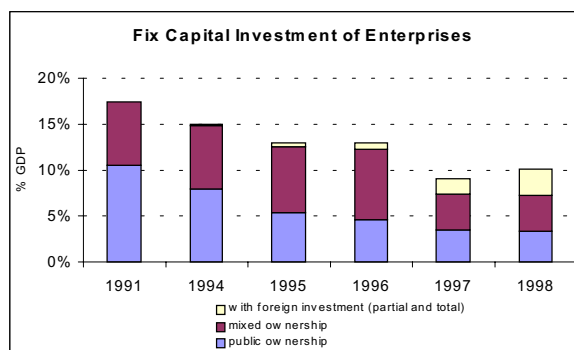


water for irrigation per ha declined 7-8 times.

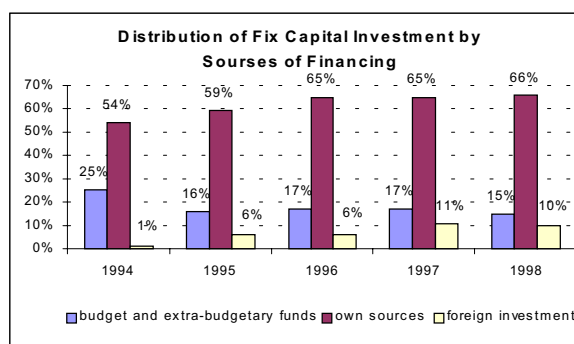
It is well known that not use of fertilizers leads to the decline of harvest per ha by 30-40%. In Moldova a large massive of land under grains was not fertilized during last 10 years. The use of chemical fertilizers per ha felt down by almost 19 times (from 136 kg in 1990 to 7 kg in 1998). The use of local natural fertilizers per ha (from 5.6 tons in 1990 to 0.1 ton in 1998) is decline in 56 time. If the situation evaluates the same way, the fertility of the well-known Moldovan black soil will decline catastrophically.

Plant protection is one of the most important part of the technological process of agricultural crops growing. According to distributors, the supply of pesticides in 1998 declined 1.4 – 2 times as a result of VAT and special custom tax. Many enterprises sow untreated seeds, spray the gardens 2-3 times instead of 8-9. Only 11% of surfaces are treated with herbicides.

Investment climate. Investment resources are important restructuring components of the national economy, prerequisites for raising the bid of production growth and for social improvement. One of the reasons the lack of GDP growth the transition period, is the scarcity of investment sources.



In the 90th, on the general background of the economic crisis, the investment activity has suddenly declined. Thus, in the GDP structure after final expenditures, the investments in the rough set up of the fixed capital have decreased from 17.5% in 1991 to 10.2% in 1998. A growth of the volume of investments (in four years–100%) was registered only at the enterprises with foreign capital. At the same time, the composition of financial sources modifies dramatically – the share of resources from the state budget and extra budgetary funds diminishes (from 25% in 1994 to 15% in 1998). The weight of the own resources of the enterprises varied from 54% in 1994 to 66% in 1998. The mechanism of accumulation of resources from the population is far from being perfect. The efforts to attract the foreign investors have not been very successful (from 1% of total investments in 1994 to 10% in 1998). The outcomes of the mass privatization didn't make more active the flow of investments.



The budgetary crisis, arrears taxes and the use of more than a half of budgetary expenses for social purposes have unexpectedly diminished the volume of investments from the state budget: in 1995 – 132.8 million lei; in 1996 – 155.0 million; in 1997 - around 130 million lei, and in 1998 – 70 million lei. As a result the incoming credit lines assisted by the international organizations, the share of banking credits in the structure of investments in the set up of fixed capital, increased from 0.8% in 1997 to 7.3% in 1998.

To encourage the investments is to develop the economic potential of a country. Consequently, in order to overcome the crisis, the share of investments in GDP should be increased to at least 25-27%, that is the lowest level in the European countries in transition. The destination of investments should be first of all the restructuring of the products and of

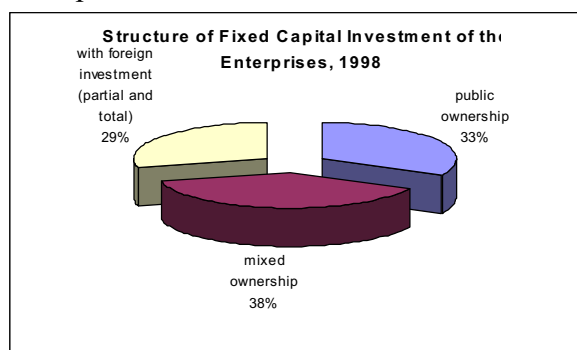
infrastructure capacity, since at the initial stage of the set up of Moldovan market economy, they have been mainly concentrated in area of services.

The main direction of the long-term investment policy is the mobilization of multiple extra-budgetary sources that shall be used in at least 90% of the capital investments. There are three such sources: own means of economic agents, the resources of population and foreign investments. In the next years, in the economic development, especially the domestic accumulations shall become the main catalyst of the investment activity. From this perspective, it is necessary to elaborate and to implement the “state economic policy”, that would let the businesses and population to cumulate resources and to turn them into investments. This will require amendments in fiscal policy, in crediting, in incomes policy and insurance against risks.

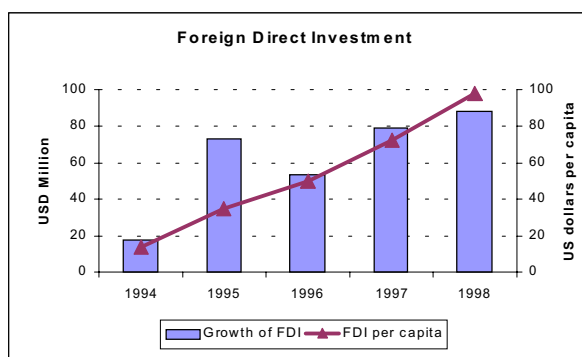
The survival of Moldovan enterprises depend on the incoming foreign direct investment (FDI), that in a relatively short period of time allows:

- to achieve the mainly new competitiveness level of the enterprises by using new technologies, know-how, introducing new operating management principles and training of personnel;
- to push up the volume of investments, to raise their share in GDP up to the level required to complete reproduction on a progressively enlarging scale;
- to promote the degree of integration of Moldova in world economy system based on the increase of potentiality of the export;
- to increase the income of the population and to cut unemployment.

Foreign direct and portfolio investments are an important source of financial resources for the restructuring of enterprises. In 1998, the enterprises with fixed investment ratio including the foreign funds amounted to 29% of their total volume. These investments have been much more efficient from the point of view of modernization and re-equipment of production (referring to “Knauf”, “Vitanta”, “Zicos” enterprises in 1997, in 1998 about three quarters of the foreign investment has been allocated to the Giurgiulesti terminal, “Lukoil”, “McDonalds”, “Green Hills”).



The volume of foreign investment per capita was of 98 US dollars. It is necessary to underline that comparing to other countries in economic transition, this volume is obviously



Foreign Direct Investment, per Capita (USD)		
	Cumulative 1989-1998	1997-1998
Albania	132	27
Bulgaria	155	104
Croatia	349	174
Czech Republic	968	367
Estonia	947	480
Macedonia, FRY	97	72
Moldova	98	48
Hungary	1652	331
Latvia	634	286
Lithuania	422	346
Poland	389	250
Romania	200	144

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insufficient. We have to note that only a small percentage of these investments come to constitute the fixed assets (in 1998 not more than 30-40%), the most significant part being spent on credits and increase of statutory funds.

The foreign direct investment is closely linked to the liberalization of foreign trade, to the adoption of free trade conditions with EU countries. Thus, the Association Agreement for Poland, Hungary, Czech Republic, Romania and Bulgaria came into force in 1995. Estonia and Latvia have ratified this agreement in 1995, and Lithuania – in 1996. In the frame of this agreement, the mentioned countries, have ratified some social conditions in order to create the free trade zone, that would allow a more intensive foreign direct investment: if in 1994, the foreign direct investment in Central and Eastern Europe and Baltic Republics constituted 3.8 billion dollars, then already in 1995, they increased to 9.7 billion dollars. According to EBRD experts, in 1998 the incoming flow of foreign direct investments in this zone constituted more than 16 billions of dollars.

The largest part of the foreign investment in Moldova is directed to the agro-industrial complex and services, mainly in small and medium enterprises. Strategically important are the investments in machinery production, cement and gypsum, infrastructure objects - terminal on Danube River, Chişinău airport, electrification of Razdelinaia-Ungheni railroad and reconstruction of the main highway.

For the renewal of enterprises equipment the future will be leasing, the creation of financial institutions assisted by foreign investors - co-owners of the Moldovan enterprises that receive equipment and its services in leasing.

In order to neutralize its temporarily and speculative nature, portfolio investment (the purchase of shares of Moldovan enterprises by foreign banks and companies) is welcome to be directed to the financing of these enterprises in exchange of shares from the statutory funds.

Energy sector, restructuring of the agricultural farms, the infrastructure of the transportation, of public municipal services, of the constructions and the social areas are considered as the areas of priority for the implementation of the Public Investment Programme.

Other areas such as telecommunications, public transportation, industry, trade – should constitute the area of private sector investments. The first PIP was designed for 3 years - 1995-1997; the new programme is designed for years 1998-2000. PIP is financed from the own country resources, from external credits and donations. The government has selected 36 investment projects for the Second PIP. Over 60% of the total volume of financing reverts to energetic, transportation and municipal economy services projects that has a purpose the country modernization.

Improvement of investment climate creates the main premises for the positive changes. From this perspective, it is necessary to reduce the political risks and to forecast the changes in political economy, legal protection of ownership rights, facilitation of free circulation of funds, development of land market and of dwelling space, improvement of management on the market of capitals.

The concrete measures for the amelioration of the investment climate from the European experience based critical years are:

- encouraging the commercial banks in providing long-term credits to the real sector (subsidizing the interest rates of the loans, differentiation of shares of allocations into the reserve funds of banks);
- development of the organizations' network specialized in financial investment – bank investments, leasing companies as well as the orientation of the non-banking financial institutions towards investment activity (privatization investment funds, insurance companies, pension funds);

- authentication of the repatriation of capital – funds, that even if considered foreign, may be used as a large financial source in the economy of Moldova;
- facilitation of tender procedures for the individual projects of privatization for money, as well as of procedures for the portfolio investment and procurement of shares of Moldovan business by the foreign investors;
- development of investments insurance system.

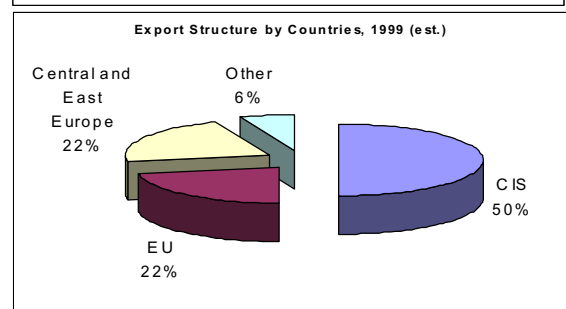
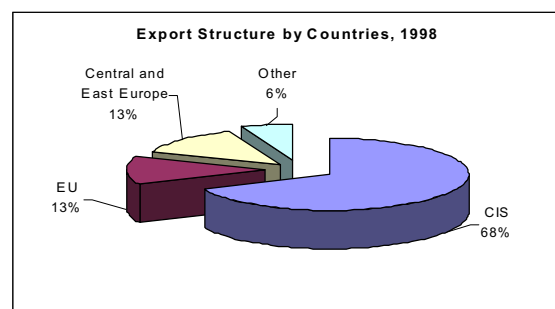
One of the possibilities of improving the investment climate is the development of investment advantages to be better than in neighboring countries. The problem is however that Moldova's neighboring countries – Ukraine (with a total population of 52 millions) and Romania (22 millions) present a much more interest for foreign investors, due to the considerable larger markets and higher domestic demand. It is inefficient to invest in a large project in Moldova, with a small sales market and to export products in the neighboring countries. That is why, it is vitally important to create conditions for investments that would be more attractive than in neighboring countries.

Liberalization of foreign trade. The free external trade policy contributes to the economic development. This is relating primarily to the transfer of advanced technology and know-how to the business management. Moldovan producers could adopt the innovations embodied in imported goods. In order to have a healthy competition on the international markets, an Economical policy oriented to export will stimulate the modernization of local firms. On a domestic protected market such incentives practically don't work.

International trade assures to Moldova the access to large markets. This is important because in a small economy, the potentiality of the growth depends on the capacity of enterprises to compete on the large markets, gaining from quantity of production. For small economies it is vitally important to reduce the barriers in foreign trade operations. International experiences show us that in a short-run a tough protectionist policy could have positive results for the country. However, in the long run such a country usually confronts much more difficulties as a result of the decline of competitiveness of its goods. The politics of professionalism has only negative effects for a country as small as Moldova, because Moldova can not be sure that the politics promoted by other countries will be the same, as a consequence Moldovan producers loosing more that they would have gained.

The accession of Moldova to various unions and trade organizations, that would reduce the barriers of the reciprocal trade between the countries, is, nevertheless, an important tendency of the external economic policy that would allow the improvement of the situation in the real sector of economy.

The re-created on the post-soviet territory the economic structure of FSU, proved to be less efficient. The shrinking internal market of these regions, the informal obstacles and the level of prices had a destabilized influence on the Moldovan enterprises. Search for new markets lead to the increased rate of non-FSU countries in the turnover of external trade of Moldova – 40%. Actually, we have to note that the FSU countries, first of all Russia, continue to be the main market for the Moldovan products – that is approximately 70%.



The same is notable in other areas. In trade of Moldova with foreign countries it is time to already to move forward from the tactics of survival to the strategy of development. The state shall make some efforts in order to facilitate the access of Moldovan producers on the European markets, to reduce the tariffs and not-tariff barriers. This would be one of the reasons of speeding up the adhesion of Moldova to WTO, the accession that will be followed by the conclusion of the agreements with European Trade Unions (CEFTA, Baltic Union, Agreement of Free trade with European Union). The Liberal economic external policy, based on the reduction of trade barriers of Moldova with European Union countries it is a good possibility to sign the Agreement of association as a member of European Union.

The possibility of concluding the free trade agreement of Moldova with the European Union countries will be discussed by the European commission after the adhesion of Moldova to WTO. The agreement calls for a more liberal trade conditions between the signatory countries in the framework of fulfillment of requirements of WTO.

From the experience of other signatory countries to this agreement, it can be expected the following:

- the free trade will bring significant profits to the real sector if there is the proper economic environment where the firms and people are free to choose the possibility of doing their business;
- reduction of the trade barriers as a component of the free trade agreement that not necessary to be advantageous in the short run for the members. In the long run, the decrease of commercial constraints will contribute to the optimization of the placement of enterprise resources, thus will contribute to the competitiveness of production;
- to make decisions of signing the free trade agreement, first of all we shall draw the attention to the barriers such as bureaucracy, corruption etc. The reduction of these obstacles will lead to the rise of government's income from the real economic sector and practically will compensate for the fall of the imported fee;
- the membership of WTO will be the pretext of signing the free trade agreement with the European Union and will facilitate the countries' participation in the future multilateral commercial negotiations;
- the country will receive social dividends as a consequence of economic development that will be the result of the incoming foreign direct investment and advanced technology. The investment and modernization of business are the key elements of the contemporary free trade agreements;
- the free trade agreement will play an important role in the speed up of the structural reforms in transition period. However, the agreement will not have any positive influence if the internal restructuring process will be inconsistent.

Finally, in the activities of the President, Parliament and Government, the attention to the situation in real sector is intensified. This gives us hopes.

7. BUSINESS CLIMATE: FROM AN INVESTOR'S PROSPECTIVE

Although the Moldovan economy has shown signs of recovery throughout 1999, it still remains very fragile. Most of Moldovan companies experienced a severe drop in their business activities, primarily in volume sales. All businesses had to face a shortage of external financing even for the working capital purposes and consequently had to finance their activities through internal, very scarce cash flows.

The year of 1999 has been a period of a very short political stability: two governments have been ousted by the opposition forces. The short ruling of the government led by the reformist Ion Sturza has brought some early positive trends into economy. That was also a period of a dynamic collaboration with international and bilateral investors and donors, characterized by an accelerated pace of privatization.

As a result of increased risk after the regional financial crisis and climbing political instability, the local banking system raised effective interest rates in 1999 and more than ever was cautious in providing credit to businesses. In aggregate, the Total Investment dropped at the beginning of 1999 both in real absolute terms and as percentage of GDP.

The high cost of capital discourages domestic investment. Tight monetary policy is usually cited as a main explanation to this. However, other two "hidden" factors should be brought to the light: 1. The massive borrowing by the public sector, especially in order to support energy providing companies, which drag huge arrears and generate new debts. 2. Inefficient domestic banking system that has high operational costs and applies thus huge spreads.

The banking sector clearly needs to be consolidated.

The whole business investment infrastructure remains week and half way between centrally planned and market oriented and perhaps is the main impediment to the investment both domestic and foreign.

The following key incentives have been provided to business in 1999 to encourage foreign investments:

- Exemption from customs tariffs on goods (including office equipment, machinery, other equipment and raw materials) which represent a contribution to the formation and increase of the statutory capital of an enterprise with foreign capital.
- Exemption from customs tariffs on goods (raw materials, semi-products, etc.) imported by an investor to be used in the production of articles for export.
- Enterprises enjoy a 50% reduction in income tax for five years, with no obligation to sell their hard currency income, provided that the share of foreign capital in the statutory fund exceeds US\$ 250 thousand and that the income received from sale of its own products (goods or services) constitutes 50% of the total income.
- Enterprises are exempt from income tax for three years if the share of foreign capital in the statutory fund exceeds US\$ 1 million.

However, these incentives provided to foreign investors could not compensate for all inherent risks: macroeconomic and political instability, constantly changing regulatory framework. The annual amount of foreign investment in Moldova's economy stood at a very low level of about US\$20 per capita. Foreign investors are complaining about red tape, corruption of

7. BUSINESS CLIMATE: FROM AN INVESTOR'S PROSPECTIVE

Moldovan authorities, especially at lowest operational level. The investors would rather give up this privileged tax treatment in exchange for clear, transparent “rules of the game”.

Another constant subject of complains of all export-import companies are the customs regulations which are frequently changed, rising confusion among the business community and different officials who apply different treatments and are often not familiar with different product codes. Additionally, exporters are faced with complex set of administrative rules designed to regulate the flow of hard currency into and out of Moldova. Under these conditions, corruption is a major problem for foreign investors. Exporters are also obliged to register foreign exchange received from the export of goods with their commercial banks.

The main inefficiencies are created in Moldovan economy by so-called **groups of interest**. These groups of interest, which have been striving to maintain their overall control over the economy and hostile to foreign investment and private ownership in such key sectors as wine-making, energy, transportation, telecommunication, agro-processing, tobacco industry, hotels. In this respect, the peculiar role of privatization investment funds (PIFs) should be mentioned. The PIFs were supposed to become a channel for investment into Moldovan companies, but instead, the vacuum of public and regulatory control over PIFs activities, lack of own resources, lack of financial experience, etc. transformed PIFs in one of main impediments to foreign investment in Moldovan economy. Presently, PIFs try to consolidate their ownership in companies, which is usually associated with fighting out existing management.

The foreign investors realized the importance to organize an institution, a “foreign investors club”.

The Foreign Investors Forum was created at the initiative of Mark Horton, former IMF Resident Representative to Moldova in August 1999. The purpose of this informal meeting is:

- assess the recent economic developments and prospects of the country;
- summarize experience of the well established companies in view of helping the new-comers via sharing information on the major obstacles/business problems;
- organize meetings with local officials;
- discuss ways to attract more foreign investments to Moldova.

As of December 1999, three meetings have taken place which included representatives of International Finance Corporation, Western NIS Enterprise Fund, EBRD, Africa-Israel Fund, Coca-Cola, IPC of Germany, SIIF of France, Voxel, Sudzucker (Germany), Esastampa (Italy)-Piele, Eurofarm (Romania)-Farmaco.

A free access to land is a critical issue for foreign investment especially in an agricultural country like Moldova. Yet, the big foreign investment has mostly remained limited to the capital. International institutions try to facilitate the investment in rural areas by setting different programs, e.g. Rural Finance Corporation, through providing technical assistance. However, the big difference would make the attraction of big, specialized agricultural investors who would come with money, technologies, experienced people.

Unfortunately, the investment climate, after a short uphill in spring-summer 1999, has significantly deteriorated. Moldova is seriously jeopardizing its reputation and runs the risk to pass in the category of “neglected” countries, slipping away from the list of priorities of investors.

8. SOCIAL COSTS OF REFORMS

The decade of transition is characterized by profound social and economic degradation. Transformations, which occurred, did not meet people's expectations. To the contrary, they resulted in a dramatic deterioration of living standards, increasing inequality, fragmentation of society and lack of social cohesion. Reform imitation and chronic political instability has undermined the basis of human development, amplifying poverty, unemployment, criminalization of power, and the disruption of the moral and institutional fabric of society. The development of transitional processes poses the following fundamental question: is the reform worth, while such painful social costs, and how much time will people enduring them?

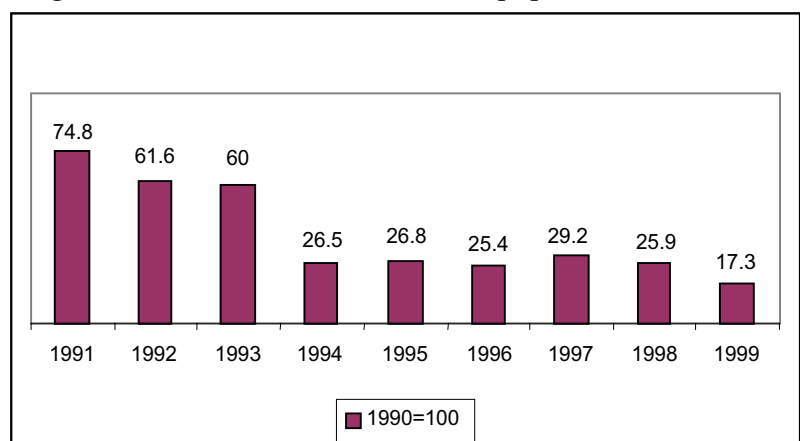
The fall in output, which was accompanied by lack of political will in promoting genuine reforms have implied severe social costs that grew up during this period of time. The number of people living below the subsistence level was about 1.7 million at the end of 1999 or 45% of the total population. Income dispersion reached uncontrollable dimensions: the index of quintile income distribution is 14.7 while in 1991 it did not exceed 7. Unemployment continues to spread at high rates, capturing at the moment about 10% of economically active population. Well-being, health care, and education, which are the components of human development index (HDI), have shown a deep regress throughout the transitional period. As a result, Moldova ceded 30 positions in the UNDP ranking of *human development index* falling down to the 104th place in 1998.

The whole population felt the negative impact of social costs but most badly it were the elderly, the disabled, the large families, and other social-vulnerable groups. Thus, the majority of people with low income, who in fact are the most needy of social protection, carry the burden of social costs. Consequently, the vulnerability and social exclusion of people has been growing. This fact is confirmed by the results of an opinion poll carried out in Apr. '99 by CISR and Foundation Soros-Moldova. The findings showed that reform brought benefits only to 5% of the population; while for 70% of them living standards have worsened dramatically.

The social costs of transition have eroded considerably *human security* many indicators of which have approached their respective critical limits. The scope of this process is very broad and it may have adverse consequences in the long run. That is why public awareness of the fact that human security is in big danger has been growing in the country. According to findings of some opinion polls, population considers its top concerns to be the problem of "*human insecurity*", stressing particularly such components as economic security, threats for health care, and personal security. At present the aggregate index of human security in Moldova represents only 1/3 of its "pre-transition" value, being one of the lowest among countries in transition.

High inflation and substantial declines in output, which occurred at the initial phase of reform, having being accompanied further by tax evasion and corruption, caused a significant deterioration of real incomes of the population. Throughout the decade in transition the synergic effect in devaluation of liquid assets was minus 83%. At the end of 1999 the real value of personal income has only 17% of that

Figure 8.1. The fall in real income of population



Source: CISR/author calculations

8. SOCIAL COSTS OF REFORMS

registered in 1990. It should be noted that the depreciation of real income took place at rates higher than the decline in output. This fact spurred the spreading of poverty.

Distributional asymmetries caused by wage imperfection provoked an income inequality never known before. Growing *disparity in real incomes and social differentiation* is due mainly to the following processes:

- liberalization of wage structure as a consequence of removing the bureaucratic impediments in wage policy and increasing the role of non-traditional sources of income;
- reduction and partial cancellation of state subsidization of public goods and services;
- private sector development and improvement of labor market flexibility;
- privatization and formation of financial intermediaries.

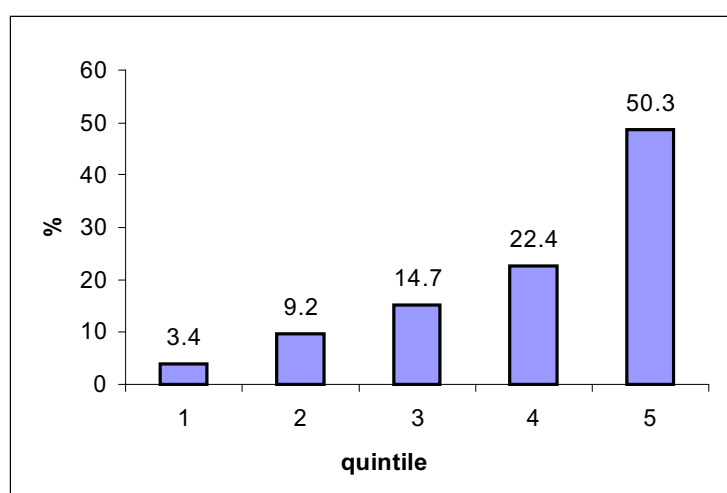
Income inequality of “*the new rich*” and “*the new poor*” is getting wider. Comparable with the 1990 Gini coefficient, which shows the degree of uneven distribution of disposable income, grew 1.7 times reaching in 1999 the level of 44.1. This is one of the highest rates of social stratification that have been recorded by now among countries in transition.

It is symptomatic that due to “distributional metamorphose” mainly the socially vulnerable groups of population have suffered, like the families with dependent children, the elderly, the unemployed, and the disabled who usually are placed in the lowest quintile and who are the poorest.

For instance, when national currency, the Moldovan leu, was introduced in November '93, the first quintile had the personal income accounting for 4.9% of total disposable income of the population, while the fifth quintile held 44.8% of it. Today the correlation between the poorest and richest groups is 3.4% and 50.3% respectively. Thus, the rich become richer and the poor become more marginalized. People with the medium level of income who constitute the main part of society hold only 46.3% of total disposable income. This is conclusive evidence that the middle class in Moldova is too fragile and cannot serve as a shock absorber to social costs of reform.

Fall in the purchasing power of population has led to a significant decline in individual consumption that obviously spurred malnutrition. From a society with profound deficit in the commodity market as was the case of Moldova at the outset of reform, now this country became a society with limited consumption. The decline occurred to all *components of consumption* (services, food stuff, and industrial goods), but sharper it was to the basic food products, like meat-minus 57%, milk-minus 49%, and fish-minus 84%. Consumption deterioration has approached dangerously to the critical limits, threatening normal human development. According to CISR findings based on household budget survey data, today less than 10% of population (mainly the richest layers of the society) are able to keep the level of consumption similar to that registered in 1990. Meanwhile almost 10% of population consume less than 1500 kcal per day that according to FAO represents the critical threshold of

Figure 8.2. Income inequality in 1999



Source: CISR/author calculations

malnutrition. The average consumption level in Moldova was 1980 calories comparable to the threshold of 2500 calories established by FAO. It should be noted that malnutrition affects today not only social groups with low level of income but also those with medium income who are employed in the public sector (mainly teachers, social workers, and nurseries) due to incidence of delays in paying salaries.

Malnutrition has affected directly *demographic indicators and the status of public health*. The exponent of life quality, life expectancy, continues to worsen substantially.

Comparable to 1991 life expectancy has shrunk by

9% being at the present

70.7 years for women

and 63.2 years for men.

The incidence of chronic and infections deceases is growing up. Now

Moldova is on the eve of explosion of epidemics of

VIC and tuberculoses. A precarious situation is

reported with the health care of children. Due to

a serious insufficiency in breeding and a poor

nutrition value of food

(which covers only 40%

of the required daily

minimum of the energy

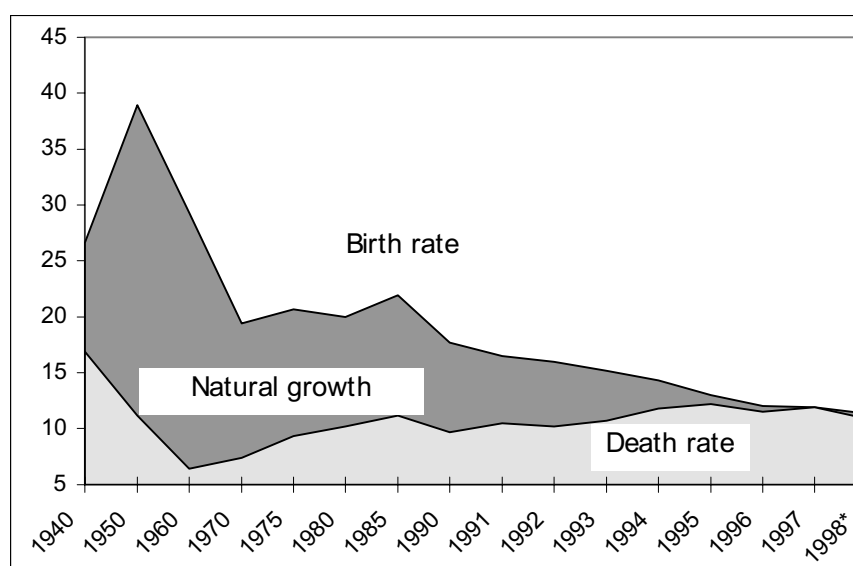
value) the number of

pathologies is growing up significantly. To date almost each fifth child suffers from some serious physical or mental dysfunctions.

Having not got sufficient financial resources to cover the cost of medical treatment the main part of population is imposed to abandon costly medical services, which are provided by the specialized medical institutions. Instead of them the poor have to treat themselves at home taking traditionally popular medicines. As a result, about 60% out of the total number of deaths and 30% of children deceases are registered at home. This fact led to the situation when the death rate stands at high level-11.1 per 1000 inhabitants being 3 folds higher than European median. Quite alarming is the trend of rising death rate among active population. Compared to 1993 death toll soared 1.1 folds capturing at present 41.6% of the total number of deceases.

One of the most important factors of human development crisis in Moldova is the lack of financial resources that are allocated for social needs. Though the share of social expenditure is pretty high, 22% of GDP, (that is comparable even with the level of some western countries), keeping unchangeable the nature of social security net has undermined the viability of social finances depriving it for a sustainable support. Additionally to that, misusing of funds, which has being accompanied by a low rate collection of social contributions, has expanded the disparity between financial possibilities and social commitments. If in 1990 the scope of this phenomenon was 15%, when in 1998 the lack of finance amounted for 44%. This is a signal that the viability of social finance is on the verge of crisis.

Figure 8.3. Demographic Trends



Source: findings of HCC under the MH

8. SOCIAL COSTS OF REFORMS

Despite robust attempts to make some changes social security net is not efficient and equitable yet. The implicit nature of social facilities has made them more dispersed. More frequently social groups with high and medium level of income get these benefits. According to a study, which was done by the World Bank in the first semester of 1999, close to 1/3 of the total social assistance benefits went to the welfare people. In general, the current system of social protection is extremely inefficient and costly for the whole economy. Overlapping and unclear eligibility criteria led to a significant increase of social facilities. Moldova like other states of NIS has a large spectrum of social facilities for certain layers of population considered “worthy” of social support, but in fact they are not the needy. Overall there are almost 1.3 million who got some sorts of social assistance facilities. In spite of energetic actions, which were undertaken towards reducing the number of social privileges, this bulk still remain to be significantly large. By the middle of 1999 they accounted for 8% of GDP.

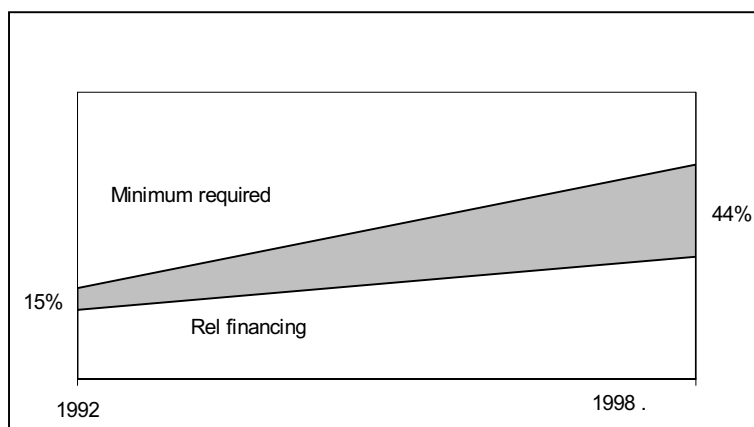
Government failure to fulfill social commitments has caused an explosive growth of *arrears*. It became a norm

delays in paying wages, pensions, social indemnities. Social arrears to public servants, pensioners, and suppliers of energy resources has registered a constant increase since the mid of 90's, reaching at the end of 1999 almost 13% of GDP. During the last five years the situation worsened because of the combination of planning overestimated revenues, the lack of reserves for unexpected shocks, and the lack of monitoring public expenditures. The synergic effect of these factors has shaped the situation of “planned arrears”.

Although during the decade of transition some attempts to change the existing social security net were undertaken, in fact it remains unreformed, keeping its pre-transitional nature. Misallocations of funds, implicit subsidy of social benefits, and the operational rigidity of social institutions attest that social protection is disintegrated and insolvent. Unfair privatization of medical and education services has undermined the assets of social sphere, limiting the access to these kinds of services only to a small number of welfare people who can afford themselves such a luxury.

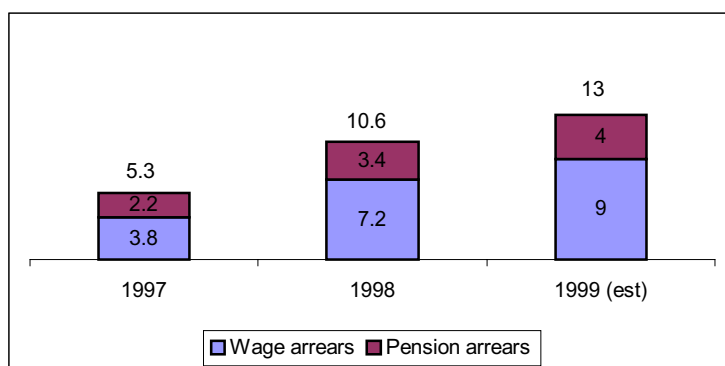
Family allocations and indemnities are provided implicitly and in a manner almost similar to that of universal social benefits. Cross-subsidization of thermal and energy tariffs was the

Figure 8.4. Disparity in social finance



Source: CISR/author calculations

Figure 8.5. Social arrears, as % of GDP



Source: CISR/authors calculations

most vulnerable point in the social security system. These subsidies absorb almost 20% of the public budget revenue and are convenient only to providers (distributors) of energy resources. Cancellation of subsidization may be hindered by serious institutional impediments, which makes this rather a political issue than social.

The administrative capability of the social institutions is too weak and this fact might be a serious impediment to performing social protection reform. Besides that the lack of public information regarding the aim and scope of social reform led to strengthening the position of opponents and intensifies the hesitance in promoting reform.

The cumulative effect of profound deterioration of living standards has been materialized in the *massive pauperization* of population. The incidence of this phenomenon became more frequent covering new social strata. According to some estimations completed by the UNDP-Moldova today more than 80% of the population have the daily income less than two dollars. Regardless the fact that there is no an official estimation of poverty threshold so far, as a preliminarily benchmarking of poverty might be used the estimations provided by the household budget surveys. According to that in 1997 circa 35% of population was living below the absolute poverty line of 82.1 lei monthly income per person. The 1998 regional crisis, which contributed significantly to the output decline, has intensified poverty escalation. Using the same poverty line yet at the beginning of 1999 almost 46% of the population was poor. Therefore we can conclude that poverty is growing at high rates that might undermine seriously the effectiveness and viability of social policies.

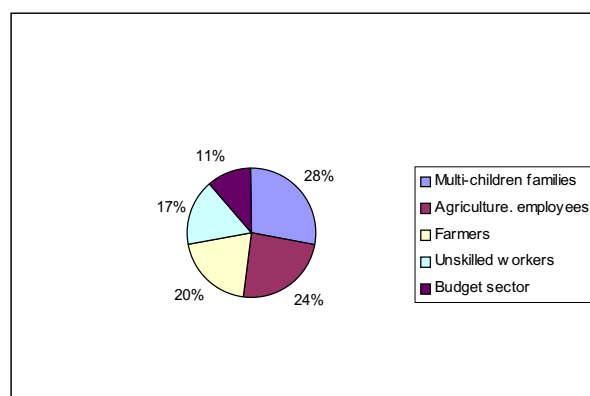
The situation is becoming more difficult due the fact that poverty, which was considered at the beginning of reforms to be temporary and short lasting, now seems to change into a long run phenomenon, capable to accompany the reality of Moldova for many years. The arguments for this statement might be the following reasons:

- fragile and unsustainable income basis;
- high extent of vulnerability of Moldova's economy of its external environment;
- significant decline in employed labor force ;
- insignificant capability of economic units to absorb the excessive labor force;
- insolvability of current social security net.

From the perspective of macroeconomic policy, poverty in Moldova is a labor market phenomena spurred by the limited opportunities to find a paid job. The incidence of poverty among employed people, particularly those in agrarian sectors, demonstrates the imperfection of wage and employment policies. Preliminary estimations reveal that some 7% of GDP are needed to reallocate for poverty eradication programs. This task is hardly achievable in condition of a profound economic recession.

At present poverty profile is much diversified and more complex than at outset of the transition. Apart from families with many dependent children, the elderly, and disabled who usually lived below poverty line, now this social illness has penetrated into employed groups in agro sector, the unemployed, and even low quality workers from budget sector. For all these social groups poverty line is much higher than the average poverty threshold of 45%. It is worth mentioning that the presence of children is close related to the probability to be affected by the poverty. This happens due to "dependency burden", i.e. the necessity to support on the modest sources of personal income several other members of household who do not gain money for life yet. As a result the process of emerging

Figure 8.6. Profile of the „new poor”



Source: Opinion pools and HDS'98

“poverty pockets” is intensifying and this could amplify social segregation and marginalization of population.

Situation is getting worse due to the fact when main part of the society barely manage to survive and cannot allow even the minimum living standards they had previously, in the actions of “new rich” an irrational consumption behavior takes place, which manifests itself in an arrogant exhibition of their welfare. This phenomenon (taking into account dubiously sources of income) cannot to no provoke disgust and protest of grass roots.

Thus when the mass pauperization has a large scope, and the main part of the society is located at the limit of biological subsistence, the fight for physiological surviving becomes the main challenge. Because the official employment is no longer a secure source of income and the chance to find a suitable job is less significant, untraditionally ways are used to secure the income. Among them are follows:

- small street trade (vending),
- leasing out dwelling houses,
- providing services by using personal cars,
- unofficial labor migration,
- trading with agricultural products.

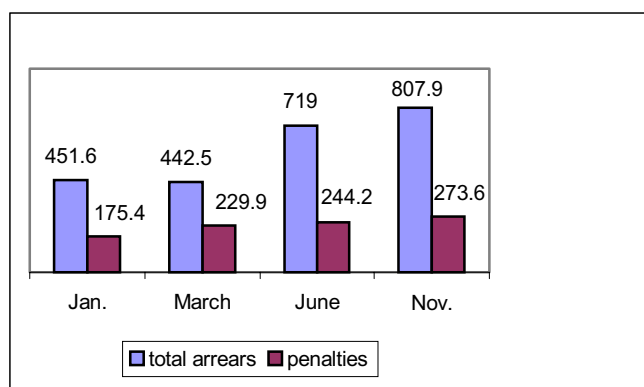
In a situation when state possibilities to meet people’s social needs are limited, *self-employment and entrepreneurship* are emerging as new factors in ensuring the human security, and as an approach of “self-protection” in this turbulent time. Property reform and private initiative have modified the structure of employment in Moldova: during the period 1995-1998 the share of employees in the public sector has shrunk from 34% to 26%. At the same time private sector’s employees increased from 60% to 66%, and for joint venture companies from 6.4% to 8% respectively.

The retrospective analysis shows that one of the most popular methods to gain means for life has become self-employment. During the past 5-7 years in Moldova a new social category has emerged which has been creating independently its labor sector and its new jobs. These are small enterprises that provide services and commodities, selfemployment in the social sphere (healthcare, education, culture), but mostly popular approach is the individual unorganized trade.

The data of opinion poll and analysis of household budget survey show that in the country almost 40% (but in the rural areas more than 60%) of individual income come from self employment, individual labor activities, and other unrecorded jobs. In many cases this is informal shadow economy.

Small business required insignificant resources from centralized public funds and is reported to be the *sector of physiological surviving* for those who were fired, demobilized from army, youth without professional training, the elderly. It is the sector of confirmation the professional abilities and practically is the only stable chance for welfare recovery. Entrepreneurs are less dependent on state finances and in this sense they might contribute significantly to job creation and to reducing unemployment. In transition period small business is aimed at ensuring conditions to vulnerable social groups of surviving mainly through self-employment and informal activities.

Figure 8.7. Accounts receivable of the Social Fund, 1999



Sources: CISR/author calculations

Despite the fact that the dimensions of small business and entrepreneurship are getting larger, this kind of activity is facing with a lot of economic, legal, financial, and administrative impediments like heavy fiscal burden, limited access to the foreign markets, long and controversial setting up procedures, bureaucracy, and corruption.

Like in other NIS countries *labor migration* has become the most rapid and often the riskier way of gaining means for life. Being unable to find opportunities to be hired in Moldova the most skilled and experienced people are going abroad looking for a temporary job. For many of them this is the only sources of income. The incidence of this phenomenon is becoming more frequent in nowadays getting significant dimensions. According to some estimations the scope of unofficial labor migration accounts for 250-300 thou persons annually. Only in Moscow and its skirts there are above 40 thou people from Moldova.

But the official number of labor migration is much smaller. In 1998 only 12.5 thou persons were registered as working abroad. Mostly of them, about 5 thou were employed in Russia, in Czech Republic-2 thou, Ukraine-500 persons. The contingent of those working abroad is quite varied, but predominantly are specialties of constructors, waiters, housekeepers, and drivers. Is not exception when physicians, PC, and researchers are demanded on the external labor market. In general circa 2/3 out of those who leave abroad for a job are people with high and medium professional education. The geography of labor migration is very various and includes Russia, Ukraine, Belarus, Hungary, Romania, Greece, Turkey and other states.

If labor migration does has an official and legal basis it can bring some benefits (familiarization with new technologies and labor approaches, advanced study of foreign languages, increase of hard currency inflow in Moldova). But in the case of Moldova those who are going abroad looking for a work are doing this without any legal support. Usually people are leaving using tourist visa and then employ themselves in the "black" labor market. This fact has adverse impact exposing people at diverse risks, and not ensuring any state social protection. Obviously it is necessary to lead labor migration into legal framework, formalizing it within interstates agreements. This process has already been started. Moldova has signed intergovernmental agreements on labor migration with many NIS countries. But this kind of activity should continue with regard to those state from Central and Eastern Europe where labor migration flows are more significant.

In the line of social events of transition period the 1999-year is marked as a year of contrasts. A mix of controversial results characterizes the situation registered at the end of 1999. On the one hand some tendencies of fragile macroeconomic stabilization has occurred, on the other hand living standards worsened. Performances achieved did not materialized in tangible benefits for the grass roots. For both government and population it became clear that the social burden accumulated throughout the decade in transition is too heavy to be eradicated in a short run period. "Big bang" in revitalizing economy did not happen.

The aggregate indicator of quality of life –people's real income – has fall deeply. According to some preliminary estimations in the current year '99 the real disposable income will be by 25% less than in the previous year. This phenomenon is caused mainly by the devaluation of income sources, and firstly of salaries (wages) and pensions. Statistical data show that the average wage in economy covers only 46% of the minimum consumption budget; while in 1998 its share was 53%. Low value of income sources and the uncertainty of paying them out attests the fact that income insecurity continues to aggravate.

Despite the fact that tax collection to the Social Fund has improved slightly during the '99 year their nominal value remain to be far behind the real necessities. For instance, to pay in time current pensions some 3 million lei are needed daily. Effectively the rates of daily collections do not exceed 2 million lei. The main reason of low fiscal discipline is the financial insolvency of economic agents to honor their duties to the Social Fund. Thus the overall stock receivable debts to the Social Fund accounted on 1st October '99 the sum of 770.7 million lei has

8. SOCIAL COSTS OF REFORMS

been increasing since the beginning of the year by 70.7%. It worth mentioning that 1/3 of them is penalties, which in fact are “dead money” due to low probability of collecting them.

In order to facilitate the partial pay off of pension debts the Government issued in July '99 a decision according to that farmers and other economic units from the agrarian sector were allowed to deliver sunflower, wheat, maize, oats, and sugar on the accounts of debts to the Social Fund. Today we can affirm that this intention is carried out so far unsuccessfully. Statistical data attest that economic agents are reluctant to this idea. By now in accordance to aforementioned governmental decision were delivered only 39 thou tons of wheat from the new harvest out of 104 thou tons envisaged. Also there were provided circa 3 thou tons of oats of those 8.7 thou tons planned and only 1.6 thou tons of sunflower from 22 thou envisaged. The quantities of sunflower and maize are even less: from 109.5 thou tons of maize were delivered only 863 tone, that accounts for 0.8%, and of 20 thou tons sugar Social fund received 7.6 tons or 0.004 %.

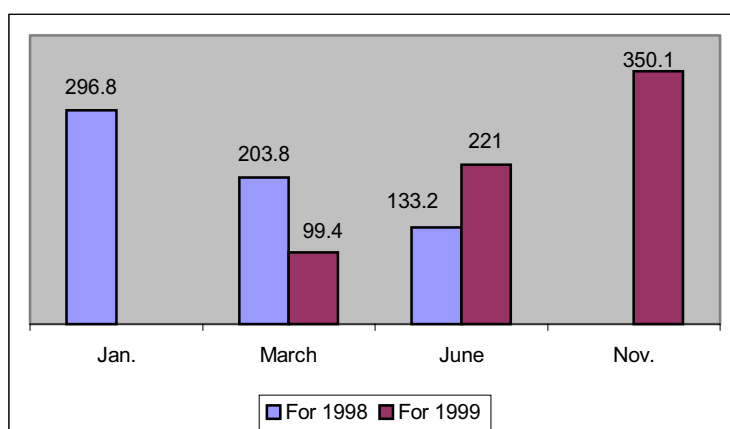
Pensions arrears, which continues to be at high level-8.4% of GDP- emerged as a derivate of unsustainable financial basis of Social Fund. It should be mentioned that throughout 1999 there were undertaken measures to reduce from the discrepancy of pension debts. It was combined pay off of debts in cash, in-kind, and on account of tariffs for the communal services. As a result the overall stock of outstanding pension debts decreased by 244.4 million lei. But the beneficial effect of these intensions was undermined by the significant increase in current debts. During the 1999 they soared 5.7 times. Thus the viability of social finance is too shaky leading to an unsustainable support.

A similar situation was reported and with regard to wage arrears. Even the overall stock of debts has shrunk by 12% during 1999 their value still remain to be impressive-14% of GDP that is much higher than in the previous '98 year. Wages debts to the budgetary institutions have risen 1.33 times comparable to the same period of 1998.

The analysis of processes, which engendered in the decade of transition and in 1999 have confirmed one more time the common rule: procrastination of social reforms and its politicization lead to a significant deterioration of living standards and to a profound human insecurity. Having being constrained by fiscal imbalances and by the excessive income stratification of the population, the decision makers gave preference to traditional scenarios that are less risky. In line with that one can remark that so far it has been putting into place the formula of piecemeal and partial changes, i.e. *quasi reform*, which is proved by practical evidences as one of the most painful and costly for the society.

Besides that social reform procrastination was influenced in main part by the environment they are implementing. High degrees of reform politization and populism, in concert with governmental frequent changes have eroded considerably the political will of decision makers in promoting deep and genuine social reform. As a result the conceptual framework of reform suffers from a unilateral approach (predominantly financial) without any coherency and consecutively. What happened in the social sphere during ten years of transition might be qualified as

Figure 8.8. Pension arrears for 1999, million lei



Source: CISR/author calculations

a mixture of palliative and fragmented measures, implemented sporadically and in an ad-hock manner.

It is clear that human security improvement depends on the efficiency of social security net. The mission of social protection must fit the new reality that shaped after ten years of transition and changes conceived should be promoted in accordance with the following three criteria: economic efficiency, social equity, and political feasibility.

The retrospective of transition decade shows that *social nihilism combined with the weaknesses of the governance* had adverse impact on social programs undermining seriously living standards. Economic reform does not limit itself only to reducing budget deficit, maintaining stable national currency, or making structural adjustments. Economic reform implies first of all the extension of opportunities for people to build up a decent living standard. An equitable and sustainable economic growth cannot be associated with poverty and human insecurity. Reform, which imposes high social costs to the population, would be deprived of social cohesion support and its outputs would be fragile.

Neglecting social and human component of reform has led to a significant drop of living standards. Poverty and income inequality endangered human security. Obviously, it is necessary a holistical approach in promoting economic reform, which will ensure a balance between macroeconomic and human aspects. Good economic policy should take into account social implications and to avoid mass pauperization.

In the context of unfavorable trends of transition period a predominantly attention on human development issue is required. Human being and its basic needs should be placed in the center of policy makers' attention, and to be considered as a major objective of economic reform. In this sense the agenda of social policy is demanded to ensure a more efficient and equitable provision of social services. The vector of further activities might be directed to the reduction of social costs of economic reform and not allowing living standards to drop below the level of human security.

Taking into consideration the scope of absolute poverty that covered more than 2/3 of the population, a priority attention should be given to the eradication of this social illness. Poverty reduction and social protection of most vulnerable groups of population might be the main concern of decision makers for short run period. Policies in this sense could combine two elements: active and passive measures. In the first case the accent will be placed on promoting the economic opportunities to the poor through job creation and diversifying social infrastructure. This could expend the possibilities of using more productively the only asset the poor have in abundance-their cheap labor force. In the second case a significant progress could be achieved by using more efficiently the social security net. Providing basic social services (access to elementary education, primary health care, and targeted indemnities and compensations) should lessen to some extent the burden of social costs on vulnerable groups. For the passive policy and especially for the social aid (cash or in kind) it is important to provide them on a means-testing basis improving the address ability of social benefits.

Simultaneously with measures of poverty eradication it is necessary to intensify actions of reforming social sphere, and firstly to relock pension program reform, and reform of education and health care system. The efforts should be centered on the rationalization of social expenditure, improving administrative capabilities of social institutions, and adjusting the portfolio of social services. This will allow to cushion to some extent social stress and to restore public confidence in reform.

9. LABOR DEVELOPMENTS IN MOLDOVA: ADJUSTMENT THROUGH PRICES OR THROUGH QUANTITIES?

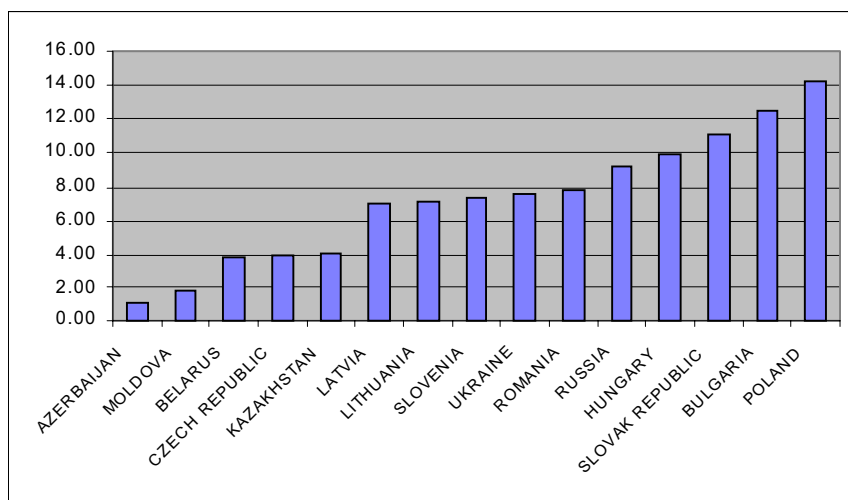
Moldova has seen one of the most drastic output decline in the former Soviet Union. Real GDP decline amounted to about 70% since independence, according to IMF estimates (IMF Staff Country Report, 99/110). The falling output, and hence falling demand for labor in the new market environment should have been reflected in the employment reductions (adjustment through quantities) or/and wages cuts (adjustment through prices). Such adjustments were especially needed as a result of earlier strategy of labor hoarding under the central planning regime. It has been widely argued that Moldovan enterprises failed to undertake the task of adjustment. In place of cost-reduction and restructuring, enterprises adopted the strategy of state aid seeking. This paper claims, however, that some adjustment does occur on the labor side. It takes forms of hindered unemployment and under-employment, and wage arrears.

In fact, established data sources (referred to as “Official” below) significantly underestimate occurred adjustments. In the paper official statistics has been accomplished with the results of Household Budget Survey (referred to as “Survey”)²⁰ to get more precise estimates of effective employment²¹. Wage data was adjusted for the stock of arrears.

Quantities adjustment. Effective level of employment

First look at data suggest that labor reduction has been done on a very small scale. Employment has shrunk only about 10% since 1991²². Moldova’s registered unemployment rate of 2% ranks among the lowest in the FSU, Central and Eastern Europe countries (Figure 9.1). Similarly Moldova’s labor force participation rate, estimated at 79.8% ranks among the highest out of a similar set of countries²³.

Figure 9.1. Registered Unemployment Rate in the FSU and CEE countries (%), 1996.



Source: International Financial Statistics Data base.

²⁰ Moldovan Household Budget Survey has been started in April 1997, with the pilot study done in February, 1997. Apart from data on households’ budgets, it gives representative information on employment and unemployment. The number of adult respondents (aged 16 and over) exceeds 3600.

²¹ Similar analysis was carried by (Lindauer, (1998)). At that time only results of the pilot study of the Household Budget Survey were available. This report is based on annual 1998 data, which is more robust and allows to account for seasonality.

²² Data on GDP and employment here and below in the article excludes Transnistria region.

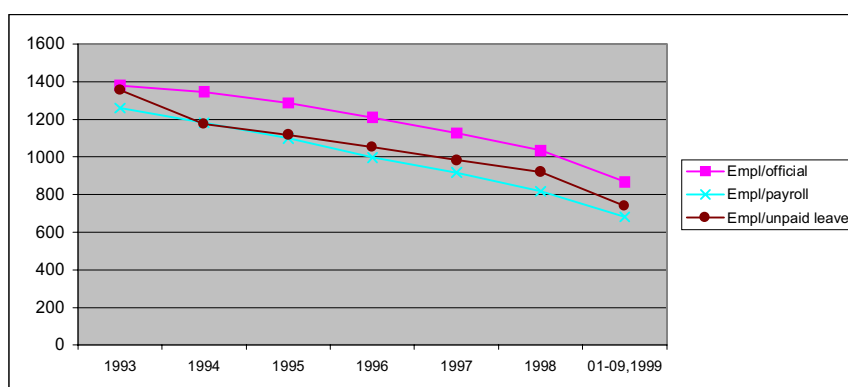
²³ OECD-CCET Labour Market Database, (Lindauer, 1998) and (Alisson and Ringold, 1996).

However, a closer look at data gives different conclusion. Actual level of employment and labor participation is much lower, with open unemployment rates appear well-above single digits.

The total number of employed in the economy in 1998 amounted to 61% of the adult population²⁴, according to official statistics. The Survey data suggests that the number of employed ('those who had job during last seven days') in 1998 was 48%. Thus, the effective employment in 1998 was 13% of the adult population (or 347 thousand people) lower, making **employment reduction of 29% at least since 1991**.

Other information on employment available from official sources only covers enterprises with 20 or more number of employees. Thus, it does not reflect the employment situation in the whole economy, but gives some insights about who is effectively employed.

Figure 9.2. Employment Official, on Payroll and Adjusted for Unpaid Leaves (1995-01.09.1999, Thousand).



Source: Department of Statistics, own calculations.

Unpaid leaves (though statutory forbidden) are very common in Moldova (Figure 9.2). Though since 1995 the number of unpaid leave shows a declining trend, in 1998 it still amounts to 11% of the employment (at enterprises of 20 or more employees) or 120 thousand employees. This is similar to Russia, where unpaid leaves amounted to 11.5% in 1998 (Denisova (1998)). Employees prefer to be nominally affiliated with an enterprise, even it seizes its operations and they get no salaries because of benefits (housing, medical, etc) they might continue to receive. Employers also favor labor hoarding as to avoid social costs associated with firing together with financial costs of paying severance payments plus accumulated wage arrears. Labor hoarding also helps employers in aid-seeking bargaining. This tradition, in fact, goes back to the times of planned economy. Thus, those on unpaid leaves are effectively unemployed.

Payroll employment figures are smaller, as they include unpaid leaves, maternity and sick leaves. However, the gap between payroll employment and employment adjusted for unpaid leaves has been increasing since 1996 (See Figure 9.2). Given rather stable and small number of maternity and sick leaves, this could possible suggest that payroll figures are the more exact reflection of the effective number of unpaid leaves²⁵.

In general, employment shows a declining trend. Since 1993 payroll employment shrank some 46%. This, however, indicates not only adjustment phenomenon *i.e.* employment reduction in response to negative external shocks, but also restructuring processes in the economy. The number of employed at medium- and large-scale enterprises shrank due to the relative growth of small-scale enterprises. Since 1996, the number of peasant farms, which represent the majority of small-scale enterprises has seen almost four-fold increase in the framework of the Land

²⁴ Here and below adult population include ages 16 and over.

²⁵ Inadequate methodology does not allow to determine the number on unpaid leaves at a given moment of time. Data is cumulative, those on unpaid leaves are registered throughout the year.

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programme²⁶. In 1999 only 5062 enterprises were covered by the Official data compared to 7474 at the end of 1993. Thus, roughly 1/3 of the employment decrease can be attributed to the reduction in enterprises' coverage, while 2/3 or some **30% reflect adjustment processes**.

How much unemployment is there in Moldova?

Official and survey data offer similar estimates of registered unemployment, roughly 1% of the adult population in 1998. Such a small number is explained by the fact that costs of being registered as unemployed outweigh the benefits. Unemployment compensations are small, difficult to obtain and are paid with a lag. As a result, only one out of four officially registered unemployed gets the benefit, which on average was equal to 80 lei in 1998 (US\$US 15). Adding workers on unpaid leaves, or 112 thousand on average in 1998, raises unemployment based on official data to 6% of the adult population for an unemployment rate estimated at 9%.

Survey results are more comprehensive in revealing the effective unemployed. In 1998 on average 280 thousand workers declared themselves without a job during last seven days. This is almost twice the level of unpaid leaves and registered unemployment. Adding up three categories of workers (those on leaves²⁷, seeking for a job, and at enterprises which did not operate, Table 9.1) pushes unemployment to 10.5% of adult population, and unemployment rate to 17.9%.

Table 9.1. The Unemployed Out of the Adult Population by Job Status and by Area, in Percentage, 1998, 1Q and 2Q of 1999.

	%, Annual, 1998			%, 1Q, 1999			%, 2Q, 1999		
	Urban	rural	Total	urban	rural	total	urban	rural	total
On leave	3.3	3.9	3.7	2.4	4.3	3.5	2.4	2.8	2.6
Enterprise did not operate	1.8	3.3	2.8	2.3	7.1	5.2	1.2	1.6	1.4
Seek a job	7.9	1.4	4	7.3	1.4	3.7	5.8	1	2.8
Total	13.0	8.6	10.5	12	12.8	12.4	9.4	5.4	6.8

Source: Household Budget Survey.

The latest estimate is likely to be biased upwards, as it includes unemployed not actively engaged in seeking a job. However, calculating conventional unemployment rate (where unemployment is defined as working zero hours, wanting to work and seeking it) gives misleading results, as relatively small fraction of those considered as unemployed answered in the affirmative. As it is explained in Lindauer (1998), this is probably because the notion "looking for work" remains ill-defined in the society accustomed to state provisions of employment. Data on urban vs. rural unemployed who are looking for a job may suggest another explanation. Unemployed do not report they are seeking a job simply due to lack of any job opportunities, as it is the case in rural areas. In fact, in 1998 7.9% of urban adult population were seeking a job, while for rural it was only 1.4%. Thus, we argue that urban data can be a good approximation for estimates of conventional unemployment rate. Under this assumption, unemployment figure goes down to 7.9% of adult population, and the unemployment rate is equal to 14.1%.

The open unemployment rate of 14.1% is comparable to adjusted for seasonality unemployment estimates in (Lindauer, 1998). When placed in a regional context (Table 9.2), Moldova is situated at the upper end of open unemployment rates in Central and Eastern Europe which goes in line with the pace and the character of Moldova's transition experience relative to other countries.

Table 9.2. Open Unemployment Rates, Central and Eastern Europe, 1995.

²⁶ MET, Quarterly issue, August, 1999, p.53.

²⁷ Those are likely unpaid leaves.

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COUNTRY	Open Unempl. Rate, %
BULGARIA ^a	20.0
MOLDOVA ^b	14.1
POLAND	14.0
SLOVAKIA ^a	13.4
HUNGARY	9.4
SLOVENIA ^c	9.4
ROMANIA	8.0
CZECH REPUBLIC	3.5

a. 1994

b. Seasonally Adjusted.

c. 1993

Sources: Moldova, author's calculation. Other countries are all based on labor force surveys as reported in Lindauer (1998), Allison and Ringfold (1996).

Annual data suggests that unemployment is higher in urban areas, 13% of the adult population versus 8.6% in rural areas. It may be somewhat misleading, as annual rural data does not reflect peaks of unemployment due to seasonal factors. First quarter (which is a still season for agriculture) of 1999 has seen unemployment of 12.8% of rural adult population, while in the second quarter it was 5.4% (Table 1). In fact, unemployed agricultural workers reported in the first quarter that in most cases their enterprises were not operating, or they were sent on leaves.

Under-Employment

Along with open unemployment, under-employment is another indicator of labor utilization. Hours worked are usually used to measure the extent of under-employment. According to Household Budget Survey, in 1998 almost 10% of the employed worked less than 20 hours last week and about 30% worked from 20 to 40 hours (Table 9.3). That is on average 40% of employees were not on full-time employment. Such a high level of under-employment in Moldova is driven in the first hand by the situation in rural areas. There 47.5% of employed reported to work fewer than 40 hours a week, although in the cities it is also high – 28% correspondingly.

Table 9.3. Under-Employment. Weekly Hours Worked, Total, Urban and Rural, 1998.

Hours Worked	Total		Urban		Rural	
	Nr.	%	Nr.	%	Nr.	%
< 20	609	8.7	140	5.0	469	11.2
20-29	932	13.2	232	8.1	700	16.7
30-39	1245	17.7	425	14.9	820	19.6
40-49	3176	45.1	1438	50.5	1738	41.5
>50	1077	15.3	612	21.5	465	11
Total	7039	100	2847	100	4192	100

Source: Household Budget Survey.

Observed under-employment is to a great extent involuntary, especially in rural areas. Widespread low-working hours coupled with double digit unemployment rate reflect lack of employment opportunities in Moldova resulted from poor performance of Moldavian economy.

Participation Rate

Employment reduction occur either through increasing number of unemployed or those out of the labor force. Apart workers who are joining the latter group due to age, health and family reasons, there are also those who have given up trying to find work. Relative size of the labor force (*i.e.* employed and un/under-employed workers) and the remaining population of working age is measured by participation rate.

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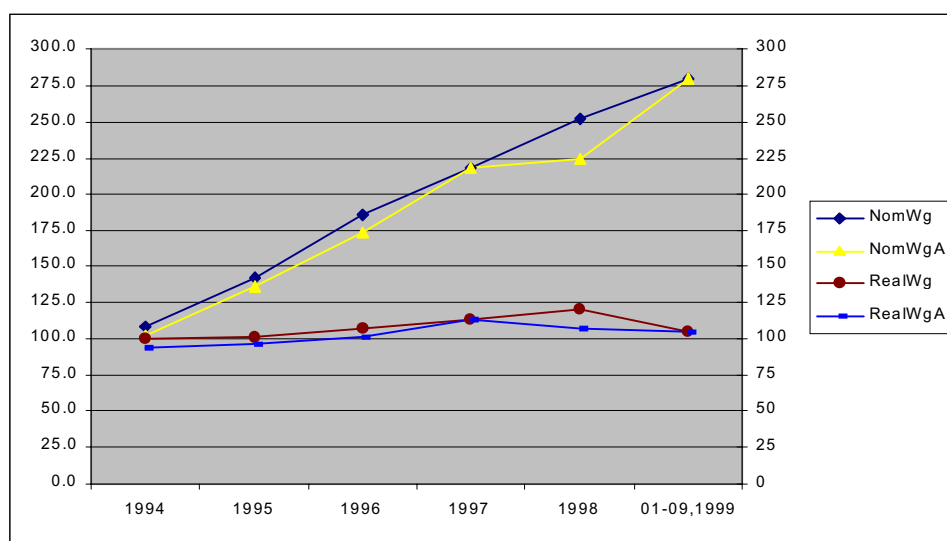
Moldova has high participation rate of 79.8% compared to other OECD economies. However, this rather reflects relatively small number of working population in the country due to low official retirement age coupled with distribution of population skewed to old ages²⁸. Participation rate indicator measured as a percentage of the adult population is more comprehensive. According to official figures, in 1998 36.5% of adult population was out of the labor force, survey estimate it even higher - at 44.1%. For both men and women the dominant explanation why they are out of the labor force is age.

Thus, effective participation rate in Moldova is not high due to low participation of older workers. It results in a heavy burden on those who are employed²⁹.

Prices Adjustment

Since 1994 nominal wages in Moldova has seen 2.5 times increase. In real terms, however only slightly positive trend has been observed until 1998, which was upset by inflation in 1999 (Figure 9.3). Thus, real wages by the end of nine month of 1999 were only some 4% higher than in 1994.

Figure 9.3. Average Wages: Nominal, Nominal Adjusted for Arrears, Real and Real Adjusted for Arrears, 1994-01.09.1999.



If adjusted for widespread arrears, those developments look even poorer (See Figure 9.3). The harm of wage arrears is obvious. Though forbidden statutory, the state and enterprises borrow from their employees without their direct consent. This directly leads to worsening population welfare, contrary to the essential role of market reforms.

Official statistics is likely to understate actual wage levels. Under-reporting is common due to tax reasons, small-scale firms and self-employment with higher pay levels are not covered by official surveys. In any case, there is no indication that adjustment has been done through prices.

Conclusion:

Moldova has experienced some adjustment through quantities. It took forms of widespread unpaid leaves, under-employment coupled with double-digit open unemployment rate. Employment has shrunk about 30% since 1991. Open unemployment rate is estimated at 14%.

²⁸ 22% of Moldova's adult population is in retirement age.

²⁹ On average, every 100 workers support themselves plus another 167 people (Lindauer, 1998).

Though such adjustments may be considered rather modest in the light of the output decline, they are sound outcomes on the Moldovan labor market. It indicates widespread under-utilization of labor resources and shortage of job opportunities.

However, due to a hindered character, occurred adjustments do not fulfill its role in catching up for productivity losses. Instead of jobs destruction at unproductive units and freeing labor for opportunities on the new markets, artificial level of employment is preserved. Due to soft budget constraint, enterprises continue to hoard excessive labor and provide social benefits. State subsidies result in losses during redistribution process and high inflation³⁰. Closure and restructuring of unproductive firms is thus slowed down.

Low official unemployment rate results in weak and almost in-existent unemployment insurance system. It does not allow to protect vulnerable population group during the adjustment period. As a result workers on unpaid leaves *i.e.* effectively unemployed prefer to stay at enterprises in hope of some benefits and future opportunities, while currently surviving through dacha plots and street trade. Other workers have to accept arrears in wage payments and under-employment not to lose their jobs. Elder workers are squeezed out of the labor force increasing the already heavy burden for employed.

Observed negative tendencies on the Moldovan labor market mirror slow pace of structural and institutional reforms in the country. To create productive job opportunities, structural reforms must be fostered. Further restructuring of state enterprises, formal development of private sector and legal base together with macro-stabilization would necessarily lead to job creation and improving living standards.

³⁰ The costs of redistribution are analysed in (Zaman and Radziwill, 1999).

10. IMPEDIMENTS TO TERRITORIAL-ADMINISTRATIVE REFORM

Historical background. Once with declaration of independence on 27 August 1991, the Republic of Moldova joined in a process of national-statehood organization by way of setting a new legal framework, reorganizing state structures, reforming the budget, etc.

One of the objectives was shifting to local self-administration. The territorial-administrative structure existing in Moldova was too crumbled – 40 rayons, each rayon having been on average of 0.8 thou km² in area with about 76 thousand inhabitants.

Historically, in the post-war period, the number of rayons used to change often, varying between 18 to 60³¹ - unfortunately, without taking account of the historical, demographic, natural, economic or other factors worthy of being considered while establishing the number of rayons.

In the '90s the first attempt was made to motivate the new, increased net of rayons by the Planning Institute, which developed 4 variants of territorial-administrative structure of the Republic of Moldova (18, 12, 9 or 7 counties), based on a system of 24 indexes – social, financial, etc.³²

In mid-90s, the Government concluded in the end the preparatory work for launching the reform. According to new restructuring, in Moldova were created 10 judetses (counties), Gagauz Territorial Administrative Unit and the municipality of Chişinău. In October 1999 based on an amendment to the Law on territorial administrative reform the 11th – Taraclia judets was created.

The new judetses were created around certain important industrial regional “axles” (judets residences) with more developed infrastructure (railroads, highways, telecommunica-



Note: Territorial-administrative structure prior to reform.



Note: New territorial-administrative structure of Moldova without Taraclia county.

³¹ A. Gudîm, L. Nicul, M. Serbuşcă. Экономические подрайоны Молдовы, (Economic Subrayons of Moldova) “Ştiinţa”, Chişinău, 1973.

³² A. Gudîm, R. Averbuh, V. Chiţan, V. Badrajan, Iu. Pailec Предложения к новому административно – территориальному делению Р. Молдова. (Suggestions on new territorial division of the Republic of Moldova), Planning Institute, Chişinău, 1990.

serve as pillars for further development. The market economy speeded up commencement of changes in this field, due to broadening discrepancies within the territorial-administrative structure of current relationships throughout the country, which became a major obstacle in further development.

As legal basis for territorial-administrative reform were the following laws that were adopted in 1998-1999: „Law on territorial-administrative organization”, „Law on local public finances”, „Law on public ownership”, „Law on local public finances”.

In line with territorial reform the public administration reform started. The current system did not comply to the new realities, neither met new requirements. It was necessary to make a change, because it constituted a real barrier to reform promotion and state development (it also was a too big burden for the budget of the country). Particularly, it was necessary to change the poorly qualified old structure, organize services to population, enhance efficiency of local finances usage, regulations pertaining to local property, growing capacity of developing and implementing local interest policies, etc.

After laws enforcement, their implementation started in the field. It was suggested to restructure the public administration bodies in compliance with the real needs of the population. Based on those changes, the new administrative bodies became more efficient and represent an important step forward in terms of reform promotion. The process continued when the Government assigned prefects of the new judetses, when they were confirmed by the president and by direct elections of the local public administration in the communes, municipalities and judetses, in May 1999. The clear division through legal provisions of responsibilities between the prefecture and local councils need to be improved in practice and will serve as indicator of the success in cooperation between central authorities and decentralized bodies on territories.

The Europe currently operates in a new legal, political and social-economic reality – *regionalism*, which is manifested through enhancing rights and responsibilities of the regions within certain countries, and thus amplifying inter-state contacts based on „region-to-region” relations. This can be obtained by commissioning certain competences from the central bodies and not from local ones. The main problems in this context are:

- *how can be shared the responsibilities between the central and local levels with a maximum level of usefulness for both benefit of the country and region;*
- *how to handle the issue so that decentralization process does not undermine the statehood.*

Under usage of regional resources, excessive centralization of state budget, providing subsidies and subventions to most rayons, on the one hand has paralyzed the initiative, and on the other hand – pushes them into underground economy, run based on barter transactions, hiding incomes and tax evasion.

The strategic importance of the regionalism consists in the fact that the activity of any state in all aspects is carried out particularly on territories – on the region and municipality levels. It is there where economic agents, population, production and social infrastructure, natural resources, are placed, and, on how fast we manage to create legal and economic conditions for providing a productive activity based on initiative of the local public administration, to a great extent depends the success of the reforms and reviving the economy as a whole.

Given the current economic constraints the country encounters, one should expect, that sub-national authorities would have to plan and stimulate localities’ and regions’ development without banking on a considerable intervention from the center. In order to make this possible for them, the local public authorities should enjoy a real decentralization, comprising not only laws and regulations but also some additional measures in decentralizing public finances, training public office holders, etc.

Democratization process, modernization of economic, social and cultural institutions in compliance with the European Chart of Local Autonomy, which was ratified by the Parliament of Moldova in July 1997, and Moldova’s integration in European structures are directly depending on how Moldova manages to reform the local public administration. As main purpose

of reform could be considered providing for territories' sustainable development, administrative decentralization, shifting to self-financing and maximum usage of local potential (natural resources, geographic position, infrastructure, human potential, etc.), also rapprochement of Moldovan legislation to EU standards. The local public administration is the best example of democracy in the country, when local electorate elects the mayors and councils. With regard to local problems of particular importance is the fact that the law stipulates even consulting the electors.

The new legislation lead to a delimitation of responsibilities and powers between the central authority and local one, thus eliminating certain prior contradictions or drawbacks in relations between them. The essential role of the local public administration could be considered that of meeting and protecting the public interests of the community in the territories. Decentralization ranks an important place in terms of local public administration reform, which pursues to involve more and more local communities in handling the problems encountered on the territory. Reforms continuation in this field will have as consequence - shifting competences in taking decisions, pertaining to administrative authorities, from central government to local specialized ones. Fiscal responsibility is also commissioned to local administration, the main sources of budget being local financial sources. The local administration can work out and implement projects of sustainable development or various programs of local importance and is empowered to contract loans from various firms or institutions both from the country and abroad. Optimal conditions are created to set up and collect local taxes by the special departments from local public administration structures.

A real challenge for organizing the local power structures is land privatization and real transmission of powers from the former kolkhoz chairmen to newly elected local authorities. A new relationship is being built-up between the judetses administration and the one from communes and villages comprised. Involvement of judets administration in local transactions from rural localities will have mostly an aspect of collaboration, monitoring, consulting, informational, etc., the latter also constituting a manner of relations between the center and judetses. It is necessary to elaborate a new and comprehensive regional policy by the central state institutions, as well as setting up a body like Agency of Territorial Development, designed to assist and inform the new territorial units.

Premises have been created and a real trans-border cooperation started with certain regions from neighboring countries. This cooperation, provided certain previous barriers are eliminated, will lead to improving relationships with the respective states and serve as potential means for prosperity and developing the involved regions, being also an important step towards Moldova's integration in Europe (trans-border cooperation, where region has an important role in European integration).

However not everything has been realized, the new structures having encountered more difficulties due to various reasons. The judetses have to resolve the same problems that are encountered by the state, at different level, in particular the extreme economic crisis that engraved its prints on all the facets of the society. The territorial-administrative reform started in a crisis, which contracted substantially its abilities to act and financial resources. The main challenge for the new judetses administration is whether they will succeed to assume the new current reality and capacity to face and settle the new responsibilities related to that. It is also perceived the lack of trained personnel able to handle the increasing emerging problems of the local administrations and population in the territory. The local Governments are suffering due to a lack of access to information and other paradigms of development available both in the country and abroad. Their relations were so long based on vertical relations between the central government and the one from the territory, that now it is necessary to make all possible efforts to enhance the horizontal links and share experience both with the judetses from the country as well as with the regions from neighboring countries.

Of particular concern is lack of experience of the local public administration authorities with regard to local public finances management, as well as lack of cash that considerably shrinks their possibility to act. The experience is missing in the field of modern administration, strengthening capacity to manage, which is necessary in particular in such fields as: economy, fiscal, financial and human resources management, and of a higher level of transparency in relations with the public. Laws related to reform were adopted during 1998-1999, which entailed certain deficiencies in their enforcement; for instance a long period of time the judetses existed based on the budget designed for the former 40 rayons. Also much work needs to be done in adjusting infrastructure, administrative structures, adjusting the functions of the key positions in various fields of the local public administration and that of the services in compliance with the new realities. A real test in implementing the new administrative system will be the transformation of local governments into efficient bodies, truly democratic and viable. They must assume one more role, more active as compared to previous one, in terms of providing for economic prosperity of territories as well as protecting vulnerable layers of population. The activities in those fields will be problematic from more considerations: economic crisis, lack of financial means and expertise.

It is vitally necessary to develop some pilot projects focused on communes, cities and judetses development, designed to mirror the way of their current development, as well as for a longer perspective, that should also be based on the locality own realities and possibilities. This fact might provide for a certain level of continuity of local administrative structures' activity and in the future might help in determining the priority development objectives and possibilities to support them. The projects once approved, should comply to the regulations that are valid both in all candidate-countries to EU membership and member-states.

Local budgets are the most serious problem at the first stage of reforms. A considerable aspect of regional development of a state is self-administration of the local public finances. This fact is also important due to considerations that currently the living standards in Moldova have aggravated incredibly. More and more excuses are being devised and expressed, more or less plausible, such as former dry years, regional financial crisis from 1998 and its grave impact on the national economy, etc. However, very little is said about the fact, that these facts, although considerable, are only some causes of the rampant crisis, and far from being the only excuse. Let us ask ourselves - everything has been done in the Republic of Moldova to stall off the social-economic decline and resume growth?

The array of problems is far bigger, whereas their unilateral interpretation is misleading, causes incorrect conclusions and respectively incorrect definitions of manners to recover and approach the problems. The situation we reached cannot be semi-explained or semi-approached.

Unilateral approach of transition economy problems exclusively through the angle of monetarism, total ignorance of the need to support demand and population purchasing capacity, based on certain state-run studies and programs, entailed shocking social abnormalities, for whose consequences readjustment will take too many years. To reaching this state of affairs also contributed the imperfect legislation and corruption that during the period under review reached aberrant proportions.

If the reforms were promoted incorrectly at the national, judetses and local levels their impact is even more bizarre, more uncertain and more confused. More confused, first of all, due to the insufficient information provided by mass media, which generates room for gossips.

However, in the territories are most of the production factors, manpower, resources and ultimately the whole complex of inputs that should be resorted on for an eventual proper evolution of the economic operations.

These statements could be motivated by many more arguments. For instance, the opinion poll – “*Impediments to Development of Private Farming Enterprises and Related Small Rural Business in the Republic of Moldova*” – conducted by CARANA Corporation - Washington in collaboration with the Center for Strategic Studies and Reforms, reveals, that, the possibility of running a business in the Moldova constitutes a serious problem (Fig. 10.1), not only in the sense that the polled economic agents do not perceive any support on behalf of the state or that they do not feel any effect. Moreover, they state that the legislation hampers their activity.

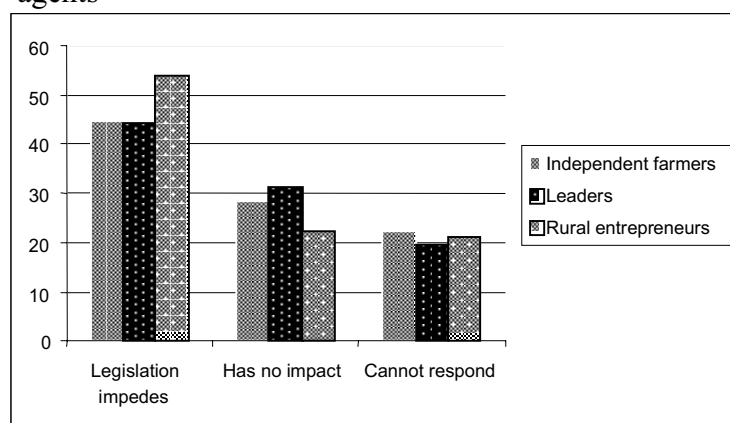
While registering the transport units and equipments, 70.5% of leaders and 27.1% of peasant-farmers encounter serious problems.

Those responses are provided by a sample comprising 60% of entrepreneurs and leaders having higher or incomplete higher education. The mayors covered in the poll also reveal some aspects that would not admit any encouragement (Fig. 10.2). Even 8.5% of them consider that the legislation is unclear, and 16.7% - that there are too many licenses.

The Law on local finances from July 9, 1999, produces an impression, that in Moldova for local budgets formation no other factors are taken into consideration than levying new taxes, duties, introducing new licenses, patents, etc. However, no sufficient measures are taken to create possibilities for enhancing the tax payment capacities by taxpayers. Probably the point from which the fiscal burden started to discourage taxpayers to honor their liabilities has been surpassed long ago. It is in this field where a computation of fiscal burden in the country needs to be made, proceeding exclusively from Moldova's realities, by taking account of the capacities of the taxpayers to pay taxes so that those are not to the detriment of the economic activity and subsequent improvement of enterprises financial position and respectively of budgets. Also, the respective law has a series of loopholes that allow considerable room for interpretations. For example:

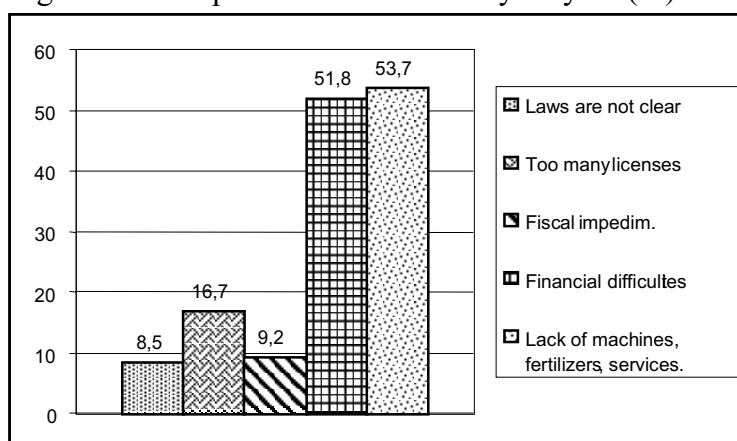
- Article 4, paragraphs (1) letter (h) and (3) letter (k) stipulate „...the duty for licenses (authorizations) for running *certain activities*;”. Based on the combination „*certain activities*” a local government office holder can manipulate as much as he wants, on

Figure 10.1. Moldovan legislation viewed by economic agents



Source: CISR / *Impediments to Development of Private Farming Enterprises and Related Small Rural Business in the Republic of Moldova*, Sociologic Report, Chisinau, Aug.Sep. 1999

Figure 10.2. Impediments as viewed by mayors (%)



Source: CISR/*Impediments to Development of Private Farming Enterprises and Related Small Rural Business in the Republic of Moldova*, Sociologic Report, Chisinau, Aug. – Spt. 1999.

his liking, based on his own material interests. A specification is required, and if the activities are itemized in some other legal act, it should be specified concretely.

- Article 4, paragraph (2), stipulates that while sharing the incomes between the budgets of the local administrative-territorial units, deductions shall be made from the following types of state general incomes: letter a) tax on entrepreneurial income of legal entities from the respective territory – *at least 50%*. It is not clear on which grounds it will be decided when will be deducted 50% or, say 80% or more? The same view refers to the letter (c).
- Article 4, paragraph (3) the incomes of the Chişinău municipality shall be formed of: 1) direct and integral collections of the following types of taxes, levies and incomes: ...letter (n): *other incomes* stipulated by legislation (it is not clear which other incomes and which law it is meant).
- Article 7, Delimitation of competences in running the public spending, point 3) maintaining the following public institutions and running the following activities: letter (i) *other institutions and activities* necessary to provide for a good functioning on the respective territory.

Such „enigmatic” style, typical to Moldovan legislation, probably will never make possible to introduce order in the public finances.

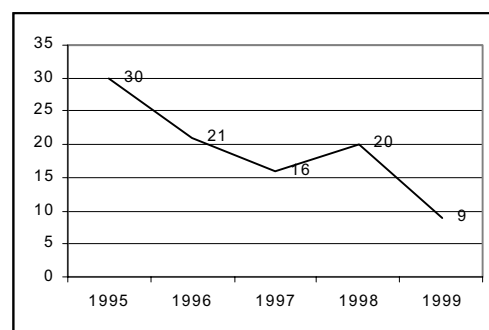
The legal controversies considerably undermine the ability of the regions, which are already uncertain and unstable, to self-support and be financially viable. (Fig. 10.3).

Although in 1999 the number of ex-rayons that transferred to budget less financial means than the amount of transfers received is comparatively smaller, the problem is still very serious to be able to regard this as some improvement. Taking into account, that of the 40 ex-rayons of Moldova during the recent 5 years, 9 of them existed only on the account of transfers from the central budget, and 6 of them for 4 years, does not make possible to draw any positive conclusions. This can also be explained by the high rate of inflation, which lead to increasing nominal value of the financial means and considerable decline of the currency.

Adoption of Law on Territorial-Administrative Reform in November 1998, will not entail an improvement of financial possibilities of judetse in itself. The law needs to be implemented in a milieu of about 35% of the former territorial-administrative units being in a state of virtual economic paralysis. The geography of those rayons is spread throughout the whole republic.

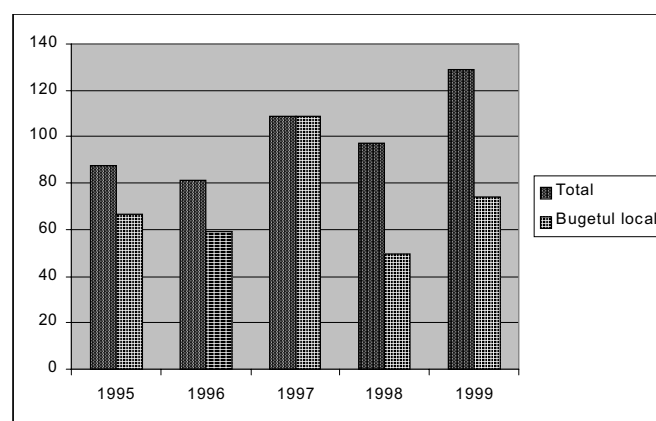
Such legal drawbacks, although not many, permit things that make the legislation a real harassment for potential entrepreneurs, not to mention the individuals who have no education, and can be tracked out practically in any law.

Figure 10.3. Number of ex-rayons that received more transfers from the central budget than they have allocated.



Source: CISR/author's calculation.

Figure 10.4. Trend of incomes and spending of the local budgets. Total per rayons (%).



Source: CISR/author's calculation.

10. IMPEDIMENTS TO TERRITORIAL-ADMINISTRATIVE REFORM

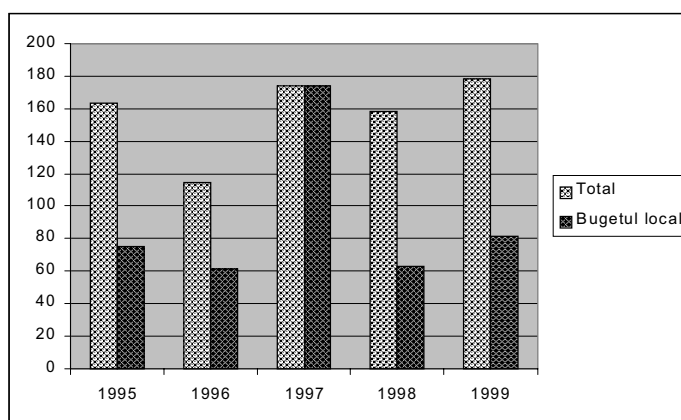
The assessment of legislation by poll respondents and existent legal problems in the manufacturing sector implies emergence of other problems pertaining to local budgets, resolving social problems, generation of financial incomes for developing the infrastructure in the regions, etc.

Having analyzed the local budgets, or the average of ex-rays of the Republic of Moldova, one can notice a very controversial state of affairs, with no trends of shaping smoothness.

In 1997, which was anticipated by two relatively problematic years, the situation stabilized to some extent, then, in 1998-1999, was followed by a turn towards instability (Fig. 10.4). If in 1995 the overall incomes covered on average 87.5% of the local public budgets' spending, 66.6% of them having been covered by own collected funds, in 1999, although the coverage of spending from total incomes increased, the difference between the spending covered by total incomes and spending covered from own collections increased even more.

Even worse is the trend of capacities to cover the spending of the local budgets at national level (Figure 10.5). In 1999 as compared to 1995, the share of spending covered by total incomes rose from 163.7% to 178.0% (by 14%), *id est*, on average in the republic, from local budgets it was consumed more than in 1995, there was a slight increase (by 5.6%) of the share of local collections in the spending side of the budgets, yet, on the other hand the difference between the share of overall spending and their coverage on the account of local tax-collections (from 95.2% to 97.1%), proves that practically the efforts to develop the economic regional development after 1995 were null. It is regretful that although costs increased in nominal terms, in real terms, due to inflation of about 30% the consumption and living standards of the most population of the republic has been continuously declining.

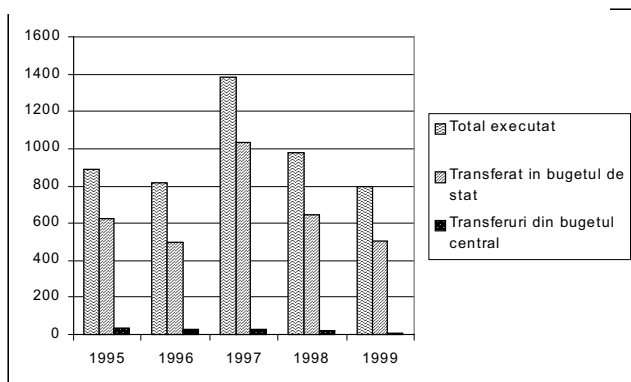
Figure 10.5. Trend of local public incomes and spending. Average at national level (%).



Source: CISR/author's calculation.

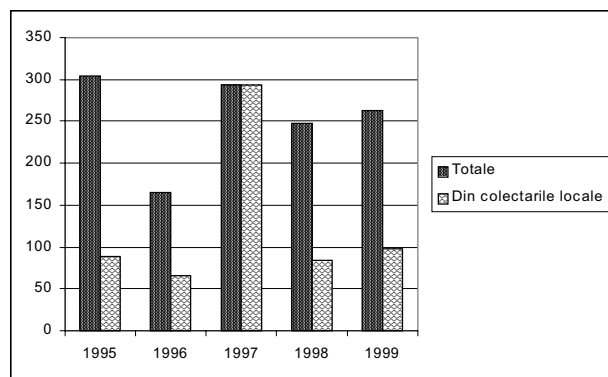
The problem of building-up local budgets is the effect and not the cause. The causes are others. The problem is that for causes are culpable somebody and the overwhelming majority suffers the effects. In situation when the legislation is imperfect, budgets creation and

Figure 10.6. Dynamics of munic. Chisinau (mil. lei)



Source: CISR/author's calculation.

Figure 10.7. Mun. Chisinau. Spending covered by incomes (%).

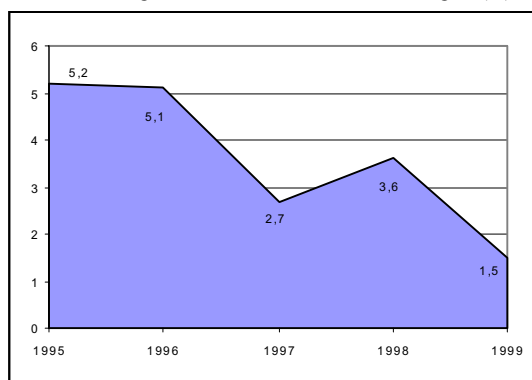


consolidation of local governments is practically impossible.

In this situation the fiscal burden on Chişinău and Bălţi municipalities is immensurable. Moreover, their fiscal capacities are also pretty unstable (Fig. 10.6 and 10.9).

On the other hand it is not clear how come that, for instance municipality Chişinău in 1998, is recorded in the financial records of local budget to have covered spending by incomes in volume of 247.7% (Figure 10.7), the share of transfer from the central budget accounted for only 3.6% from the fiscal contributions of the municipality to the central budget, and allegedly it covers its spending from own collections only in volume of 84.1%? In the figure 10.6 it is well noticed, that the share of transfers from the central budget as part of the overall Chişinău's fiscal contributions is almost unobserved, and the facts reflected in the financial documents differ considerably.

Figure 10.8. Municipality Chişinău. The share of transfers from the central budget vs. allocations to the central budget. (%).



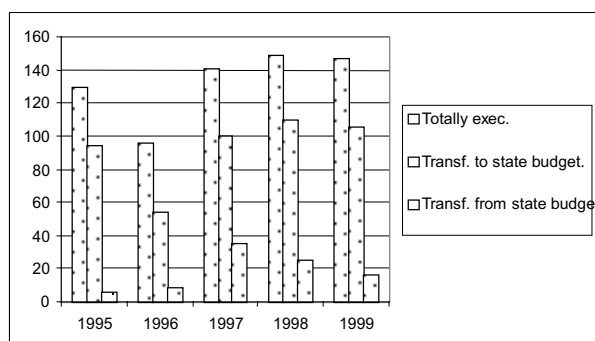
Source: CISR/author's calculation.

The dynamics of difference between the fiscal allocations to national budget and transfers from the latter to Chişinău budget reflect the situation even better. (Fig. 10.8). The town of Bălţi is also in a very precarious state (Fig. 10.9). Compared to Chişinău is bigger the share of transfers from the central budget to the total of the executed budget.

Proceeding from the state of affairs stated above, one could conclude the following:

- In the Republic of Moldova the economic development policy is far from being satisfactory. Due

Figure 10.9. Dynamics of Bălţi municipality budget



Source: CISR/author's calculation.

to this, many actions that might run in themselves, based on private economic initiatives, get stuck in the offices of the administrative bodies, so that in the end fail from the very beginning.

- Even if some intentions “break-through” and private businesses are established, they run either based on double bookkeeping or in underground economy.
- The current new business-running environment discourages cultivation and observing optimal business relations. In these conditions fair individuals are very frustrated, in many cases preferring to stay aside. Thus a continuous process is taking place of economy criminalization through a combination between corrupted public officials and delinquent “businessmen”, which are very compromising for Moldova as state. Such socially incorrect manifestations are easily emerging, yet, will cost a lot the state in terms of its image, confidence, ability to respect human security and honor its commitments as state, in case when it will be really desired to do so.
- The Law on local public finances permits many interpretations that are to the detriment of the proper run of the economic process.
- Of legal loopholes benefit state officials, who by taking bribes benefit of momentary opportunities, and undermine the process of proper running of private initiatives.
- The process of transparency implementation with regard to budgeting and budget execution continues to be procrastinated, providing access to non-government analysts to financial records in this important aspect.
- It is too high the number of patents, licenses, duties, taxes, etc., which are required for setting an enterprise.

Alternatives to resolve, at least considerably, the problems are available, as have always been. Will is required. Alternative suggestions might be, *inter alia* the following:

- In order to improve the financial position of the new judetses is necessary to adjust the legal drawbacks. It is necessary to remove all possibilities of double interpretation of laws.
- In order to intensify the financial discipline and transparency, it is necessary to introduce the practice of budgets publishing, aiming at facilitating the reconciliation of the local published budgets with the real situation stated based on audits.
- Broad dissemination of audits results.
- Initiating a profound investigation, for the Republic of Moldova, of the equilibrium point between the funds needed by the state and capacity of the taxpayers to honor their fiscal liabilities (Laffer curve). Developing a national program designed to encourage setting and growing enterprises (real sector).

Examples of reforms in other transition countries. In most transition countries, which have as final target European integration, in line with other reforms, the administrative-territorial reform was also unleashed. Reformation and tailoring their administrative structures to European norms is one of the stages of accession process. What might make us different in terms of reforms implementation is the different economic situation they were initiated. In the countries reviewed, the milieu in which reforms started was better thanks to a more favorable economic situation or the support they received in this field from the European Union. In these countries a transformation occurred of territorial units into bigger ones (in Poland), or merging some units into development regions (Romania).

Poland. As a result of the territorial-administrative reform in Poland, the number of voivodships (national territorial units), was contracted from 49 to 16. For the Republic of Moldova the experience in terms of territorial-administrative reform is a good example, proceeding from more considerations. Of those considerations, most important is the manner of approaching the relationships between the national level and voivodships.

The most important principle of government policy in terms of regional development is complying to the objective of decentralization of the local government. The central government follows the policy of regional development through supporting initiatives of the voivodships, in case when they are in conformity with the development programs (approach similar with the manner which the European Commission provides support to regional development of their member-countries). The local governments can, though not mandatory, ask for assistance of the central government in implementing respective projects of regional development. Moreover, voivodship local governments can ask the central government abandon projects of regional development that were not stipulated in the agreement on regional development of the respective voivodship.

Another principle is that of partnership. The government strategies and programs targeted to regional development need to be developed based on joint agreement with the social and economic partners. This is another principle complying to the EU norms.

The regional development policy is based on the principle of long-term planning and not on ad-hoc interventions. This is why regional development programs and strategies need to comprise specific tasks, priorities and financial means that need to be allocated for being realized within a certain number of years. This principle is an imitation of European norms, which in case are not respected, assistance is not provided by EU.

Instruments of regional development policy, as main form of voivodship support programs, are target subsidies from the central budget. According to EU norms there is a series of programs that can contribute to regional development, and this is why, support is deserved from central funds in the fields of: (i) infrastructure development, (ii) supporting the investments made by the small and medium enterprises, (iii) creating new jobs, (iv) enhancing education, (v) environment protection, (vi) cultivation of cultural inheritance and (vii) research and regional development.

The financial means allocated for implementing the regional development policy derive from the central government budget and regions' contributions. The target subsidies from the central budget will be guaranteed in the annual budget law, by way of setting a plafond on allocations designed to finance specific objectives established in the government program of regional development. Only in exceptional cases the regional development program can bank on the 100% funding from the central budget; mainly cost-sharing is considered from regional and local sources, as well as foreign contributions.

The self-government body (voivodship council) is in charge for regional development policy of the respective voivodship and the key partners of the central government in implementing the national policy of regional development.



Romania. The regional policy in Romania represents one of the basic components of the reforming process and is aimed at removing social and economic disparities that used to exist previously between regions, starting their regional sustainable development through aggregating sectorial activities and

assuming responsibilities of a state, which desires to adhere to EU. In order to support the economic development of judetses, the National Agency for Regional Development was set up. The Government and Parliament of Romania have initiated a process of

legal improvement and amendment, that were necessary for a proper activity in the territorial-administrative field. Those changes are necessary because they represent one of conditions that lay on the basis of criteria of Romania's integration into European structures and a precondition for access to the Cohesion Fund of the EU. In 1997 with PHARE assistance the study „Green Book of Development” was developed, where eight development regions were delimited, which encompassed 41 judetses of Romania on volunteer basis. Principles, objectives, institutions and tools have also been proposed that are necessary for further development in this field. This division was made in compliance with the human, industrial, material, sectorial infrastructure available and economic activities in the region. In the regions, Local Regional Development Agencies were created. The aim of those Agencies is to support local development by working put and implementing various projects designed to improve the economic performances. Romania also joined in sound trans-border cooperation and in setting Euro-regions that are an important component of the European integration process, with countries like Moldova, Hungary, Bulgaria, Ukraine, et al.



Conclusions. In the process of territorial-administrative reform implementation the Republic of Moldova needs to assume the task of resolving in practice the main problems of setting local-government bodies on new economic grounds.

Providing certain real authorities with regard to social and economic processes, management is of crucial importance. In this regard, it is necessary to review the nature and forms of relations between the central and local bodies of the executive power, to decentralize the state budget in the sense of furnishing the territorial bodies with municipal ownership and local budgets with a sufficient basis of incomes.

Proceeding from the practical needs of the territorial-administrative reform from the Republic of Moldova and primordial tasks in the administration of the new territorial units in each judets and municipality, already in 2000 it is necessary to work-out a specific business-plan (territory development strategy), that should include:

- evaluation of judetses' (municipalities') development factors and potential;
- concept of judetses (municipalities) development for a period until 2005;
- priorities (problems, sectors, enterprises) of sustainable social-economic development of the territories;
- an economic mechanism for local self-government and relations with the central Government;
- developing 3-4 business-plans in the priority problems and sectors designed for regional economic growth;
- a program to train the staff of the local public self-government.

The new local governments will attain this way, from the very beginning a framework-document that would allow a well-determined organization of its activity in the social-economic development of the territories.

11. FIGHTING CORRUPTION TO IMPROVE GOVERNANCE

The analysis of the economic development of all countries in transition shows that this process is much more problematic than expected at the beginning. Moldova's three-fold economic decline in the past nine years has placed it at the lowest level of GDP per capita (US\$ 454) amongst the transitional countries. The decline is evidently not solely a result of combined unfavorable climatic conditions, the war in Transnistria and the lack of financial resources. Rather, an added major reason for this performance is an inefficient governance. Lack of experience and professionalism in governing a newly formed sovereign state, unfavorable economic conditions, permanently changing circumstances, lack of understanding and support from the population's side, lack of political will and fear of making major steps towards market reforms, and last but not least, the realization that the average life of the governments so far has been too short to allow for significant changes, have all contributed to the poor level of governance in the country. But, perhaps, the single factor with the most negative impact on the governance and the development of the country has been corruption. Over the last few years, the problem of corruption intensified in a number of transitional countries, and in some cases took over the structure and function of the state, with inevitably dire consequences.

Borrowing the analogy with epidemics, corruption can be viewed as a disease capable of fast spread at multiplying rates, unless the proper dose of vaccination is applied in good time and with sufficient coverage. Moldova, like many other countries, has been facing the problem of contagious corruption for decades. The initial phase of the process of transition (1989-92), from an administrative, command system to a market system did not interrupt the unofficial connections at the top level of the officials, of those who had the privileges and the priorities in accessing goods, finances, information and services. Adherence to a political "clan" was a kind of guarantee for their protection, and for barring legitimate security authorities from having access to information on their activities, including criminal activities. This kind of exclusivity at the top level meant that while the number of corrupt persons was relatively small the scale and dimensions of corrupt transactions were large and extensive. At a later stage of transition, identified with certain level of capital accumulation (1993-95), the number of such transactions increased significantly.

During 1996-1999, when the real legal incomes of the population declined and the reserves were exhausted, small acts of corruption became a "norm" of behavior.

Such quantitative evaluation of the evolution of corruption phenomenon, as are the sociologic opinion poll, would not be objective because of poor public access to information. Thus, while in 1989-1994 the information regarding the findings of auditing bodies was confidential, and in 1994-1998 the access to it still limited, by contrast in 1999 the results of the Accounting Court Audits were published in "Monitorul Oficial". This was a step in the direction of some transparency.

Corruption is a transnational problem. Data of the opinion poll carried out amongst 150 of top-level managers in more than 60 countries showed that corruption in those countries was viewed as the most serious problem impeding the development of the countries concerned³³. According to some surveys by the World Bank, the NIS hold the first place in terms of corruption.

Corruption became a main concern of global policy in more recent years. In 1999 alone several international forums took place including Global Forum on Fighting Corruption

³³ EBRD, 1997, Transition Report 1997 – enterprise performance and growth, (London European Bank for Reconstruction and Development)

(February, Washington, hosted by Vice-President of US Al Gore), The IX International Anti-Corruption Conference (September, Durban, South Africa, Transparency International), the Second Annual Meeting on fighting Corruption (November, Istanbul, OECD), as well as local anti-corruption conferences (November, Budapest, Central European University, November, Riga, USAID), etc. In his address to the Board of Governors of the World Bank Group, at the joint Annual Discussion (September 1999), the President of the World Bank James D.

Wolfensohn mentioned: „... Countries may come up with sound fiscal and monetary policy, if they do not have a complete legal system which protects human rights, property rights and contracts, which gives a framework for bankruptcy laws and predictable tax system; if they do not have an open and regulated financial system and appropriate regulation and behavior that is transparent, their development is fundamentally flawed and will not last”.

Corruption, has a strong impact on the economic, social, politic and ecologic development of a country.

The economic impact of corruption is far-reaching in many countries, as data from numerous studies in this domain show. Vito Tanzi³⁴ uses empirical data to argue that corruption serves as an *obstacle against three main functions of the state – macroeconomic policy, resource allocation and redistribution of goods and welfare*.

One of the manifestations of the economic impact of corruption is the *increasing costs of transaction*, particularly in carrying out small business activities and diminishing the competitiveness of the products and services. According to some estimates, the additional payments to obtain licenses, for so-called “protection”, and for an expeditious settlement of formalities by state officials amounts to 40% of the profit.

The economic instability exacerbated by the expansion of the underground sector, by rackets, corruption and bureaucracy in preparing business documents, and the Government’s inability to ensure producers’ security *discourage investors and innovative ideas*.

Paolo Mauro³⁵ has offered a model to find the *impact of corruption on investment and growth*. He shows that a fall of the corruption index (Transparency International) by a medium square deviation (2.4 points) is connected with a 4 percentage points growth in the share of investment in the economy and a 0.5% increase in the rate of economic growth.

Shang-Jin Wei³⁶ has analyze the *impact of corruption on direct foreign investment*. He has found that a unit increase in the corruption index (on a scale of ten) is equivalent to a 4.7 percentage points increase in the marginal tax rate, and is accompanied by a decline of 0.9 percentage points in the direct foreign investments.

A study by the World Bank³⁷ (1996) shows that countries with a high level of “predictability” of corruption are characterized by a “gross investments/GDP” rate of 19.5%. In countries with a low level of predictability of corruption this rate stands at only 12.3%. It is not surprising, therefore, that in countries with combined high predictability and low level of corruption this ratio is as high as 28.5%.

³⁴ Tanzi, Vito, and Hamid Davoodi, 1995, “Government Role and the Efficiency of Policy Instruments”, IMF Working Paper N97/139 (Washington, D.C.: International Monetary Fund)

³⁵ Mauro, Paolo (1996), “The Effects of Corruption on Growth, Investments”, IMF Working Paper N96/98

³⁶ Wei, Shang-Jin, “How Taxing is Corruption on International Investors”, NBER Working Paper Series, Working Paper 6030

³⁷ Segal, Philip, The Hell of Corruption, *The IFC Review of private Investment in Developing Countries*, Spring, 1999, Vol.3,Nr.2

11. FIGHTING CORRUPTION TO IMPROVE GOVERNANCE

An inverse link between *corruption index and public investment*³⁸ is investigated by Vito Tanzi and Hamid Davoodi.

The phenomenon of corruption actions taken in favor of some individuals, evasion of tender and competitive procedures causes an increase in the cost and a *drop in the quality of public projects*.

Corruption creates inequity, unfair competition by using the state institutions and diminishes the economic efficacy. A study by Gupta, Davoodi, and Alonso-Terme³⁹ shows that there is a strong correlation between corruption and the degree of inequity in the country. But the main economic impact of corruption is certainly the *growth of shadow economy*.

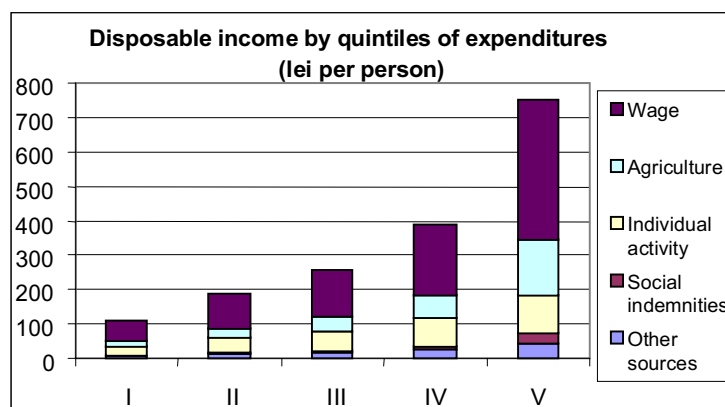
The combined impact of corruption, shadow economy and crime is manifested by the *macro-economic instability and the country's vulnerability to financial crisis*. The annual macro-business turnover in Moldova is estimated at US\$ 200-250 million, which is 3.5–4 times higher than the annual foreign direct investments in Moldova, and than the amount of foreign currency reserves with the National Bank of Moldova. The drug traffic is an area controlled by very few people. Therefore, any single capital outflow or inflow triggered by this sector alone could, in fact, impair the stability of the financial system.

The relation between corruption and economic development is dual: on the one hand, the low level of economic development and incomes stimulates the rise in corruption. On the other, corruption disturbs the development in the formal economy, and stimulates the development of shadow economy.

Social impact. The shadow economy *creates work places, that reduce the unemployment level*. The significant gap between the official record of unemployment rate (about 2% according to Statistical and Psychological Analysis Department, and 9.4% based on the criteria established by the International Labor Office) and the fact that more than one third of the able-bodied population is officially treated as inactive, without clearly stating any source for their livelihood, suggests that a considerable proportion of population is involved in informal economic activities. The calculations by the Strategic Studies and Reforms Center show that about 47% of the labor force is involved in such economic activities.

The shadow economy *generates additional income* for the participants and members of their families, and sometimes it is the only source of their living. This sector's existence in parallel with the formal economy, in fact, generates 60% of additional income. This income is, however, *unequally distributed* among the population and the gap between the rich and the poor

Figure 11.1



Source: Department of Statistics and Social Analysis

³⁸ Tanzi, Vito, and Hamid Davoodi, 1997, 'Corruption, Public Investment and Growth', IMF Working Paper N 97/139 (Washington, D.C.: International Monetary Fund)

³⁹ Gupta, Sanjeev, Hamid Davoodi, and Rosa Alonso -Terme, 1998, 'Does Corruption Affect Income Inequity and Poverty?', IMF Working Paper

is actually greater than that stated in the official records. Hence, the consumption of meat in families officially stated as having the same level of income is on average 60% higher for those employed in the private agricultural sector, where the level of informal activities is higher than it is for those engaged in the public sector.

The vulnerable layers of society are the most severely affected by social inequity, which is in turn worsened by protectionism. With no political influence, the vulnerable layers of the population are often subject to increased social pressures. Thus, according to the Household Budgets Survey carried out by the Department of Statistical and Sociological Analysis with the financial assistance of the World Bank, in 1997 the social benefits received by each member of the families at the highest level of income (level V by disposable income is about five times higher than those received by families at the lowest level of income (level I). An inequitable social system inevitably appears where layers of population earning a higher income enjoy most of the social benefits. An unfair social system is thus created sustained.

The activities in the underground sector of the economy are not entitled to social assistance and protection from the state: the requirements with regard to working conditions, working time and minimal labor remuneration are not met. There is an abuse of the work performed by minors and women, the system of temporary sick leaves is not in operation, the system of official holidays is ignored, so is the pension system, etc. A special case is the illegal employment of Moldovan citizens in other countries. There are not any agreements between the Republic of Moldova and other countries on the export of labor force. Therefore, there are many cases where upon the completion of work, the individuals illegally employed abroad are paid less than initially agreed, or are not paid at all and expelled from the country, or they become enslaved by some local criminal organizations. During 1999 alone the Public Prosecutor opened 50 criminal files for firms offering “services” of illegal hiring abroad. At least 4000 of citizens of the Republic of Moldova have been affected by the activities of these firms, extorting more than US\$ 600 thousand.

The presence of a large underground sector gives *rise to an excessive tax burden*. The state budget is dependent for its income on formal economic activities. However, most of budget expenses also serve the interests of those people who are not paying taxes (such as subsidies in energy bills, use of public services, etc.). Therefore, while the average tax burden for the economy is about 30%, the actual tax burden on some economic entities operating within the formal economy is certainly higher (40-60%).

The shadow economy and corruption *impede human development of the nation:* an increased level of tax avoidance reduces the budget receipts, which in turn, causes problems in devising and implementing appropriate social, pension, education, health, environment policies. A weak legal framework erodes moral principles of the society. According to an opinion poll conducted as part of the “Development Strategy” project, about 52% of the respondents believe that it is impossible to conduct a business activity in the country without breaking the law. There occurs the situation where breaking the law becomes a standard behavior.

Another effect of shadow economy lies in its *adverse impact on consumers by providing them with low quality goods and services*. The findings of a production quality inspection on a network of trade outlets conducted by the National Standards, Measurement and Certification Center show that breaching the standards / infringements ranges from about 40% of the total food products to 70% of goods for children. In imported goods the rate is as high as 79%.

In many cases a parallel economy functions in direct connection with the criminal world thereby *threatening the personal security of the people*.

The impact on the political security of the state

Corruption *favors the emergence of an economic and political clan*, which imposes its wishes on the society, causing an enormous increase in state debts. Moldova has very high debts on energy. Nevertheless, it imports gas at a much higher price than the world price, charging no transit fees on gas carried over the territory for re-export. Notably, the transit charges for gas on the territories of the neighboring countries exceed Moldova's GDP. Moreover, the installation of incoming and outgoing gas meters on its territory is delayed.

The increase in the level of tax avoidance and the decline in the budget receipts have contributed to the failure of policies with regard to enterprise and small businesses and social support, education, health, environment and the remuneration of public sector's employees. This, in turn, impoverishes the population further, and *undermines the confidence in promoted reforms*.

The Government's inability to ensure that its employees are paid decently paralyzes state institutions, *prejudices citizens' rights and guarantees which are ensured by the constitution*, discredits the state system, and causes the state to lose public respect.

The impact on environment. The fact that certain groups of people impose their interests on the society in order to obtain immediate profits without "amortization" of environmental resources, results in environmental deterioration.

International comparisons. According to the evaluations of Transparency International, Moldova is placed in the group of countries with a high index of corruption. On a descending scale of 0 to 10 (with 0 representing total corruption and 10 total lack of it), Moldova scored 2.6 in 1999. According to this scale, Moldova is placed on the 76th place, after Romania, but having a considerable gap, and on the same line with Ukraine, followed by Armenia and Russia.

However, there are some other evaluations of the quality of governance and the spread of corruption in different countries. In a joint study by the EBRD and the World Bank an opinion poll of about 3000 managers from 20 countries in transition was carried out (about 115 enterprises in every country, with a larger sample in Ukraine and Russia). The questionnaire included direct and indirect questions in order to evaluate the impact of corruption and poor governance on the private firms' activity and economic development of the whole country.

Firms were asked if they were satisfied with basic services that need to be provided by the state for the proper functioning of markets.

These services were grouped in

Table 11.1.
Corruption Index, 1999

Slovenia	6
Estonia	5.7
Czech Rep.	4.6
Poland	4.2
Lithuania	3.8
Slovak Rep.	3.7
Belarus	3.4
Letonia	3.4
Bulgaria	3.3
Romania	3.3
Moldova	2.6
Ukraine	2.6
Armenia	2.5
Russia	2.4
Albania	2.3
Georgia	2.3
Cazakhstan	2.3
Kyrgyzstan	2.2
Yugoslavia	2
Uzbekistan	1.8
Azerbaijan	1.7

Source: Transparency International

Figure 11.2



four large blocks: *law and order* (judiciary, corruption, street crime, organized crime), *microeconomic governance* (taxes and regulations), *macroeconomic governance* (policy instability, inflation, exchange rate), and *real infrastructure*.

Data from the poll show that amongst those 20 countries in transition Moldova holds the 15th place from the top in terms of microeconomic governance (the index being equal to 0.52 out of a maximum of 3.0), the last place for the quality of macroeconomic governance (the index being 0.35), the last place for infrastructure (index being 1.42), and the last but one with regards to law enforcement (index being 1.1). According to the aggregated quality of governance index, Moldova holds the last place, with an index of 0.82.

Table 11.2

Quality of governance index

	Micro-measures	Macro-measures	Infrastructure	Law and order
Hungary	0.92	1.72	2.42	2.34
Slovenia	1.17	1.73	2.26	2.23
Estonia	1.25	1.74	2.38	2.17
Uzbekistan	1.4	1.44	2.11	2.16
Armenia	0.55	1.15	2.21	2.32
Poland	0.96	1.53	2.37	1.82
Slovak Republic	0.88	1.68	2.11	1.7
Czech Republic	0.8	1.35	1.57	1.97
Belarus	0.67	0.77	2.18	2.25
Lithuania	0.69	1.7	2.19	1.48
Azerbaijan	1.02	1.59	1.73	1.56
Croatia	0.67	1.18	2.13	1.62
Bulgaria	0.9	1.25	1.77	1.49
Kazakhstan	0.75	0.72	1.85	1.68
Georgia	0.67	0.93	1.78	1.47
Ukraine	0.34	0.77	1.76	1.68
Russia	0.47	0.65	1.91	1.54
Romania	0.45	0.6	1.49	1.48
Kyrgyzstan	0.46	0.48	1.85	0.98
Moldova	0.52	0.35	1.42	1.1

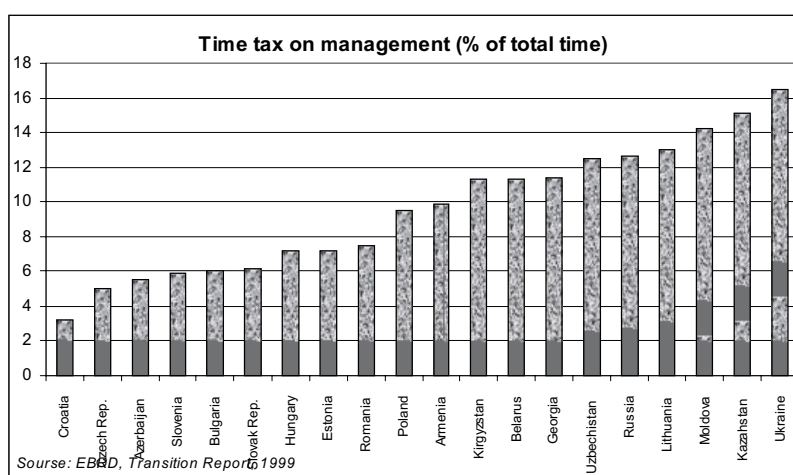
Source: EBRD, Transition Report, 1999

It is difficult to appreciate how objective this evaluation is, since the interviewees came from different cultural and psychological backgrounds. This means that the attitude of the respondents towards notions such as “corruption”, bribe, public servants ethics and integrity differs from country to country.

This difference was evident also amongst the official representatives of anti-corruption institutions from different countries during the second annual Anti-Corruption Meeting in Istanbul in November, 1999. Those from Russia were arguing that 500 dollars in Russia is not a bribe, but an oral form of gratitude. Those from

Kyrgyzstan, considered giving a sheep to someone a sign of respect and gratitude. It is also

Figure 11.3



11. FIGHTING CORRUPTION TO IMPROVE GOVERNANCE

perhaps natural that while evaluating a situation, respondents would make comparisons with their own situations in the past, rather than make international comparisons.

Figure 11.4

In spite of the fact that these evaluations could not be entirely objective, it is clear that the position of Moldova in these terms is unfavorable. Thus, about three quarters of Moldovan firms mentioned that the legal system does not protect their property rights. In Estonia, for example, only 22% of the firms feel unprotected. Moldovan managers of enterprises spend 17% of their total working time with public officials. This is the top figure amongst all countries in transition. In Croatia this time constitutes only 3% of the total.

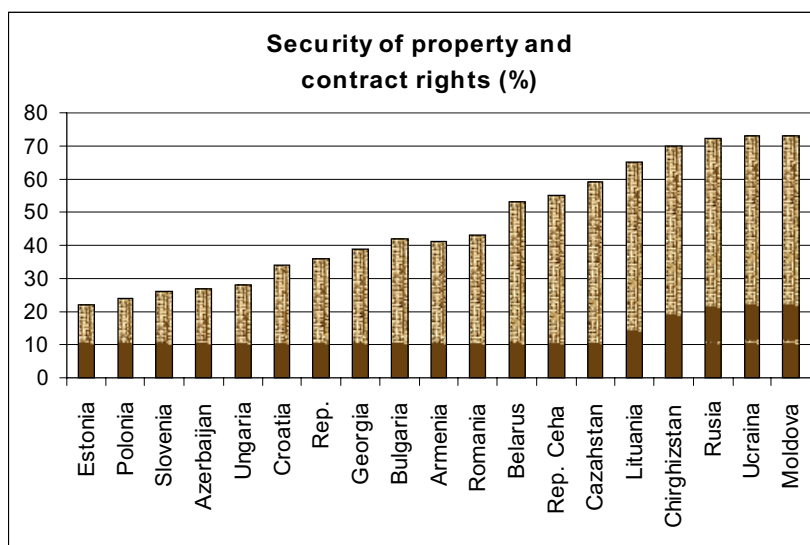
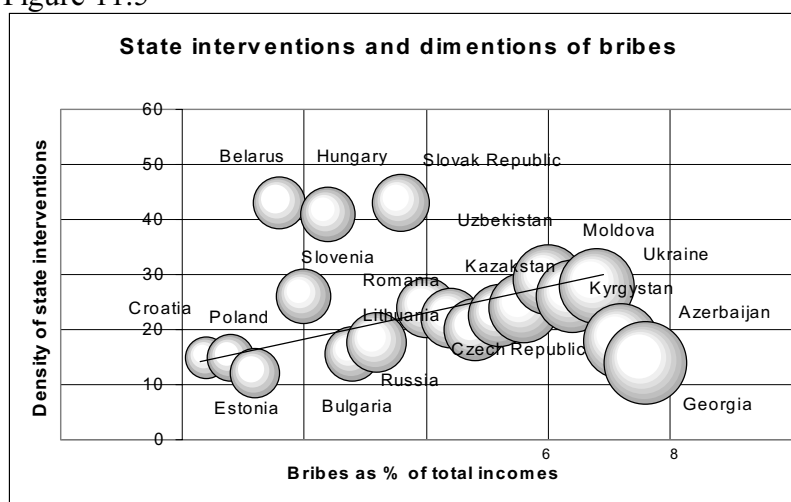


Figure 11.5

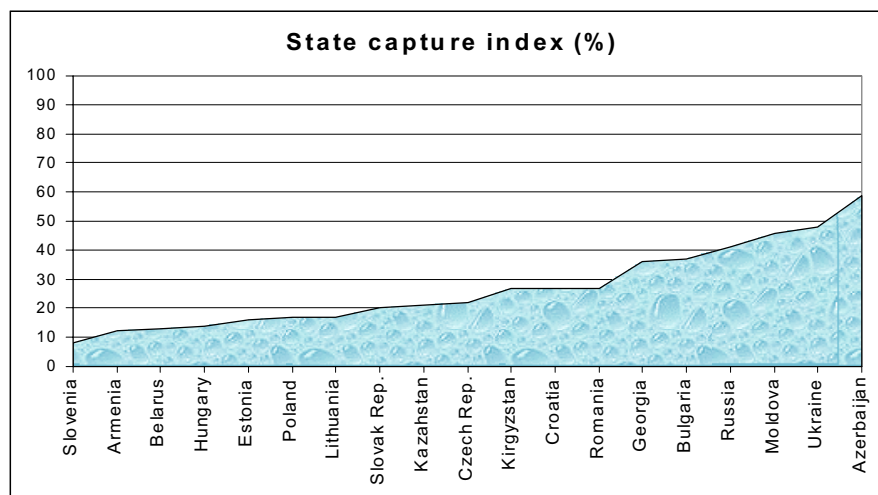
In principle, these results are not surprising. Data of the Survey on Identifying the Impediments to Development of Private Farming Enterprises and Related Small Rural Business in Moldova carried out by the Center for Strategic Studies and Reforms in collaboration with Carana Corporation show that auditing bodies create obstacles for the development of private business by frequent extortion of money. Thus, in 1998-1999 25 farms were visited 12 times by the fiscal inspector, with 12 of the entrepreneurs visited as frequently as 15-20 times. One entrepreneur complained that he was visited 50 times by the fiscal inspector in one year. Nine entrepreneurs were visited by the fire inspector 11 times over one year, one visited 30 times. Visits of the electric nets inspectors are not less frequent : 32 companies were visited 12 times, 10 companies between 16 to 100 times.



State Capture Index⁴⁰ proposed by the EBRD stands at 46% for Moldova. Only Ukraine and Armenia face a more difficult situation than Moldova in this respect. According to the data from the above-mentioned poll, about one third of Moldovan firms pay bribes very often. According to this indicator, Moldova is placed in the middle rank of all transition countries. Regarding the relative scale of bribe in comparison with total annual income, Moldova is placed amongst the first five countries. A more discouraging situation for the producers can be

mentioned in Georgia, Armenia, Azerbaijan and Ukraine. A direct relationship between the density of state interventions and the magnitude of bribes, as well as an inverse relationship between the degree of privatization and the corruption index have been established by these findings.

Figure 11.6



Source: Transition Report, 1999, EBRD

State budget deficit and unjustified expenditures.

Moldova permanently faces the problem of budget deficit. This is not only due to the fact that it is almost impossible to reduce the expenditure side in a significant way, but also due to an unrealistic estimation of the budget revenues. For instance, the phenomenon of growing tax evasion is not taken into consideration. As a result of such unrealistic estimates, various sources of revenue in 1998 budget fell short by 8.7% to 300% in reality. The Law of the Budget for 1998 was subjected to five rounds of changes. In itself underlining the poor quality of governance.

Poor governance implies pauperization of population. During 1998 salary arrears grew by lei 276 million. In some areas retired people received their pensions for December 1998 as late as in November 1999. Numerous programmes supporting education, science, health, environment, the elderly, families with many children

Table 11.3

Frequency and extend of the bribe tax

	Percentage of firms bribing frequently	Average bribe tax as % of annual revenues
Armenia	40.3	6.8
Azerbaijan	59.3	6.6
Belarus	14.2	3.1
Bulgaria	23.9	3.5
Croatia	17.7	2.1
Estonia	12.9	2.8
Georgia	36.8	8.1
Kazakhstan	23.7	4.7
Kyrgyzstan	26.9	5.5
Lithuania	23.2	4.2
Moldova	33.3	6.1
Poland	32.7	2.5
Czech Republic	26.3	4.5
Romania	50.9	4
Russia	29.2	4.1
Slovak Republic	34.6	3.7
Slovenia	7.7	3.4
Ukraine	35.3	6.5
Hungary	31.3	3.5
Uzbekistan	46.6	5.7

Source: Transition Report, 1999, EBRD

⁴⁰ "State capture commonly refers to the extend to which government policy -making is unduly influenced by a narrow set of interest groups in the economy who provide private benefits to politicians" ("Transition Report, EBRD, 1999)

and entrepreneurs all failed due to the lack of budget revenues. At the same time, there were remarkably numerous breaches in the fiscal legislation.

According to the Report of the Accounting Court of the Republic of Moldova on the results of control over the management and utilization of public material and financial resources for 1998, as a result of the lack of an efficient system of control on the part of the State Fiscal Control and State Custom Department, tax evasion has become a “norm” for the majority of economic agents. It is argued that the budget revenue could have been twice as high otherwise.

In 1998, the Social fund administration applied certain methods of accumulating the social insurance funds involved fake documents and netting out accounting between social fund and commercial entities. This has probably resulted in unjustified expenditure of some considerable amount.

Against the background of spread pauperization and the stringent financial resources, it is even less justified for the state apparatus to continue to procure new cars, and allowing the disappearance of the old ones without any trace. A brief comparison between the typical official cars of 7 years ago and the present time reveals the considerable difference in their degree of luxury as well as the market value, normally standing at around US\$ 40,000 each. In 1998 there were purchased 5 cars for the State Chancellery for 40-50 thou dollars each, in 1997 Ministry of Internal Affairs procured 5 BMW cars and 20 – VAZ for the amount of about 200 thou dollars, Jeep Toyota Landcruiser for 30 thou dollars each for the Department of Financial Control and Revision.

Illegal privatization. The findings of the above-mentioned official body also reveals numerous cases of misappropriation of public funds. This causes considerable losses for the state budget. There are detected cases of illegal privatization of public property, avoiding the tender procedure, synthetic reductions in the estimated value of enterprises in the case of privatization by the personnel of the enterprise, as well as other forms of reduction of the value of enterprises (falsification of the year of establishing the enterprise, intentional smoke-screening?, or concealing the units belonging to the enterprise, exclusion of the former workers and retired staff from the privatization list, etc.

Illegal export-import. The problem of illegal exports and imports has expanded in alarming proportions. The volume of non repatriated currency is growing continuously. In 1996-98 the practice of under-selling of exports resulted in lei 500 million according to the estimates by the Accounting court.

Transnistrian problem creates additional losses to the state budget of the Republic of Moldova. In 1997-98 more goods were imported to Transnistria than to the rest of the territory, with respectively 1.7 and 3.1 times more for spirits, 9.7 and 19.4 times more for alcoholic beverages and 252 and 90 times more for cigarettes. This is particularly remarkable given that the population of Transnistria makes up a mere 12-15% of the total population of Moldova. Then it should be clear that the main consumption of the imported goods takes place in the mainland (the right side of the River Nistru), but without any contribution to the state budget by way of paying the due imports duties.

Public procurements, manipulations of prices. Data of the report of the Accounting Court also contain numerous cases of breaking the rules of public procurements. Instead of adhering to a transparent tender procedure, services of some firms with questionable reputation are accepted with prices exceeding the market level, and the benefit shared between these firms and the public officials involved. The outcome is the transfer of considerable sums of public money to some private pockets, bypassing the market procedure of privatization, and hence distorting the market mechanism still further. A case in point could be the contract signed between the social Fund and the S.A. Petrol, concerning sugar

made from sugar cane imported from Brazil. The imported sugar was 65 bani per Kg above the market price. The presumably private profiteering out of this single contract amounted to more than lei 1 million, equivalent of the monthly wage of some 12,000 people in Moldova.

Another case: Social Fund supplies to S.A. „Petrol” 1196.5 tons of fodder wheat for a price of 263.2 lei per tone (1998), more than half of which was bought for a price of 450 lei per tone, which inflicted another lei 124.2 thou of losses to the State budget.

An example of import-export barter transaction in which the price for the goods were exported under market price, and imported goods – for an exaggerated price is the one made according to the contract for the firm „Hellis-Mag” for the export of 30 thou tones of sun-flower seeds, 30 thou tone maize, 15 thou tones of fodder wheat and 5 tones of oats. As a result of the transaction there were “lost” 4.9 million dollars. The report of the Accounting Court contains a great number of this kind of cases. The most sad is the fact that these transactions take place in the organizations where the most scarcity of financial resources takes place: Social Fund, Ministry of Health, Ministry of Education, penitentiary system (while the average daily expenditures per one convicted person is 0.7 lei).

The question of whether these transactions happen due to corruption or due to bad governance caused by lack of professionalism, does not really change their economic effect on the society.

Sale of forfeit goods. This presents an activity during which a considerable part of the value of goods “remains” in the hands of the public servants involved. This is particularly the case with smuggled sparkling wines, which were sold after being seized without a tender procedure for a three-fold reduced price. As a result, the budget lost lei 357.3 thousand. Another loss of lei 631.6 thousand was inflicted for similar reason regarding sales of vodka⁴¹.

Energy sector. Probably, the biggest corrupt transactions take place in the energy sector. Moldova’s debts for energy grow by an average annual US\$ 60 million, while the country continues to risk a total lack of energy resources. At the same time, improving the situation in the gas sector alone could solve the problem of debts for the whole energy sector. Thus, the absence of proper metering system in Moldova implies that losses of gas are estimated arbitrarily. These losses were estimated at US\$ 20 million over 1995-97. The reduction of such losses requires a verification of the actual consumption of gas first. Moldova pays for gas through a long line of intermediary firms, which transform the original payments in kind to payments in cash, and vice versa. This inevitably raises the transaction costs, and hence the price. While energy-related debts grow, the intermediary firms remain the sole profiteers out of the worsening situation.

One possible way to improve the situation is to establish a viable arrangement of payments for the transit of the Russian gas through the territory of Moldova. It could allow the annual collection of about US\$ 60 million, which could cover Moldova’s consumption of gas. The thing is it is not done because interests of a small group of persons prevail over the interest of the whole country.

Improving the quality of state governance cannot take place without reducing the corruption. Fighting corruption takes place by promoting transparency and accountability, establishment of control and law enforcement. In order to achieve this, a sustainable orderly system of governance is essential.

The implementation of a *policy for combating corruption* needs some extensive reforms in legislation, as part of the institutional reforms, and improvement of the system of regulation of fiscal audits. Although all these measures need to be implemented by the Government, they also require sufficient efforts on the part of the civil society:

⁴¹ Report of the Accounting Court, 1999

Legislation reforms would include:

- A clear definition of a penalty system for law breakers and adopting the Civil Code;
- Improving the preventive anti-crime measures;
- Appealing to the assistance by the international institutions in fighting corruption and economic crimes, applying for a global system of monitoring;
- Appealing to projects financed through foreign technical assistance to provide juridical expertise of laws and amendments proposed for adoption, improving the legal system, removing of contradictions and ambiguities giving rise to multiple interpretations of laws and regulations.

Amelioration of fiscal control procedures supposes:

- Simplification of regulations of state controls and audits, reduction of frequency of controls, systematization and unification of the work carried out by different audit agencies, establishing a unit for registering and regulating the number of controls of the same enterprise;
- Finalization of fiscal and accounting reforms;
- Publishing clear information regarding controls, rights and obligations of control agencies, of fiscal information, transparency of preparation and execution of state budget, including its sectors;
- Introduction of a mandatory tender system for public procurements.
- Reforming the fiscal and accounting systems, simplification and ensuring its transparency;
- Improving the qualification level of the control and audit personnel.

Institutional reforms foresee:

- Reduction of the number and size of state institutions, reduction of staff;
- A reduction in the “politicking” or political rhetoric within the Government, in favor of engaging in more crucial issues of governance, and the introduction of an obligatory system of professional promotion on the basis of performance and contest;
- Creation of independent institutions authorized to investigate the corruption charges;
- Introduction of a clear and definite system of ethic standards for the state employees;
- Applying methods other than personal visits for solving problems by using mail, including e-mail system, in order to impersonalise the process.

As *immediate measures for fighting corruption* the following suggestions should be considered:

- Identification of a number of key-agencies in the domains where a concentration of efforts is required to combat corruption, elaboration of a strategy for fighting corruption within ministries and in the main directions;
- Applying income declaration procedures for state employees, starting from the top level;
- Public examination of the most corrupt cases, announcing the punishment of the lawbreakers, and the directions where obtained money is spent (pensions, wages, repayment of debts, etc.);
- An immediate installation of gas counters at the entrance and exit points of the territory of Republic of Moldova.

In November 1999, practically a couple of days before the Mr. Sturza's Government resigned, the State Programme for Fighting Crime, Corruption and Protectionism for 1999-2002 was adopted, which includes some of the above measures. As this programme was adopted in a rush, it does not contain measures regarding nepotism, and needs to be improved. But, in principle, adopting this programme could be interpreted as a positive sign for international donor organizations. Whether this programme will be implemented by the new government remains to be seen.

One of the possible ways of detecting corruption is the enforcement of income declaration. This is mostly practiced in industrially developed countries, but is not necessarily of more popular than it is in Russia or Moldova, especially amongst the top officials! In Georgia, for instance, a system is already in place, whereby government officials ought to declare their incomes when they take office, as well as when they leave their posts. The expansion of income declaration to cover all entire work force certainly requires a considerable amount of resources in time and finance.

Moreover, an Anti-Corruption Center financed by UNDP is also operating in Georgia. The American BAR Association organized a multi-level training course for the judges in Georgia. However, 80% of judges did not pass the tests, and many of them were fired. As a result of these kinds of measures, the required standards in high professions can be improved, giving probably more impetus to professional ethics. This in turn could have some impact on reducing corruption.

No Government can do it alone. In any country, an equilibrium between the state and the civic society is needed. In countries where the state is stronger than the society often a dictatorship is established, and combating corruption becomes a formal declaration. On the other hand, if the civic society takes upon itself too frequently and rather arbitrarily oppose the state, on the accusations of corruption, this may lead to continuous instability. Yet, another case is a situation where the society tolerates corruption. That is to say that while the corruption is condemned, no practical opposition takes place, mainly because no-one is convinced that it would be of any consequence.

The degree of the maturity of the civil society depends on a series of objective and subjective factors: attaining certain democratic traditions, culture, education, psychology, national dignity, social and political situation. There are numerous cases when abuse of power is treated as a cultural "norm". It is rather unrealistic to expect a high degree of self-consciousness of its power from a society that has been subject to political and other kinds of repressions. This situation is a characteristic of autocratic states, based on horizontal links and solidarity, in which a bureaucratic hierarchy of norms has existed for a long time along with a preponderance of vertical relations of domination-subordination. In countries where for many years a strong state dominated a weak economy, and the civil society manifested

relatively meagre participation in political life, where the authority of a single party or cult dominated, and corruption was a form of survival, where the ethic and religious identity of the society was destroyed, corruption overcomes the weak resistance of the newly formed civil society much easier.

Formation of an integral civil society is a continuous and absolutely necessary process. Given that the transitional countries have to go through a “condensed” version to democratize, external assistance becomes vital. In this context, a special role belongs to NGOs, especially when they are involved at the grass-root reorganization. For that NGOs must be completely independent of state structures, although in practice this is not always the case.

The anti-corruption movement is important in particular regarding the following dimensions:

- **Humanitarian**, corruption oppresses and distorts human development and gives rise to the abuse of human rights;
- **Democratic**, corruption stands in the way of democracy;
- **Ethical**, corruption impedes the development of integrity of the society;
- **Practical**, corruption contributes to market distortions and deprives the society from its potential benefits.

Measures of fighting corruption undertaken by NGOs *may be grouped in four categories: research, relations with the state, relations with the civil society, collaboration with other institutions.*

Research would include:

- Analyzing corruption phenomenon: its genesis, causes, main forms, country specificity;
- Carrying out opinion polls which would allow the evaluation of the extent of corruption, both from the demand and the supply side;
- Investigating the possible links between corruption and the shadow economy.

Relations with the state would cover:

- Assuring transparency in various sectors of public, including political, life; transparency of financing political parties;
- Independent monitoring of privatization procedures of strategic entities;
- Specialized analysis of legal projects;
- Monitoring elections;
- Elaborating proposals regarding economic and social improvements in public procurement procedures;
- Lobbying the Government in order to adopt effective anti-corruption policies.

Relations with civil society would embrace:

- Assurance of public access to the information regarding general effects of corruption in the country by using mass –media;
- Creation of public web-sites regarding corruption;
- Elaboration of educational programmes for schools and public lectures oriented towards increasing the public awareness of corruption;
- Organization of professional workshops in support of investigative journalism, training in objective journalism and professional ethics in reporting;
- Promoting an educational campaign regarding citizens rights and obligations of public servants;
- Publication of informative bulletins, studies and reports.

Collaboration with other institutions would consist of:

- Conciliatory dialog between civic society, private sector and the state regarding anti-corruption campaign;
- Coordination of efforts in educational, religious and mass-media organizations and institutions in anti-corruption campaign;
- Participation in national and international campaigns which encourage adoption and implementation of higher standards of integrity and ethics in public services;
- Collaboration with public and private institutions, with similar national and international institutions, by supplying specialized consultation and joining in cooperation and partnership programmes;
- Exchange of experience of combating corruption with other countries.

Countries can not do it alone, nor can international organizations. This was the conclusion of the Second Annual Anti-Corruption Meeting in Istanbul, as well as of the IX International Anti-Corruption Conference from Durban (South Africa), 1999. Combating corruption in a single country is almost impossible as the bureaucratic resistance would be too strong. Even if there is a certain will to suppress this phenomenon, lack of practical experience, information and financial resources reduces its effectiveness. International organizations, such as OECD, European Council, United Nations, European Union, World Bank, USAID and TACIS, with experienced staff, information, finances cannot successfully combat corruption in any country unless the will and determination stems from within the country itself. That is why the problem can be solved only in an intensive collaboration between transition countries and international organizations. In line with the technical assistance these organizations may offer the best practices from similar programmes.

Conclusion: The quality of governance is affected in an absolutely negative way by corruption. Corruption impedes economic, political, democratic, social and ecologic development of the country. Any efforts in combating corruption can only be effective if the country enjoys a sufficient degree of democracy. A mutual respect and acceptability between the society and the elected state is essential in this regard. Fighting corruption in a single transition country is difficult if not impossible. Informational and financial support from democratic countries as well as international organizations is needed. International Forums on fighting corruption have concluded that it is highly important to address this problem.

12. POLITICAL STRESSES OF THE YEAR 1999

The year 1999 was a turbulent year for Moldova, a year when perhaps for the first time since independence a serious attempt to reform Moldova's fiscal system, economy and public administration was made. Surprisingly enough, bold reforming efforts of Mr. Ion Sturza's Government resulted in some significant improvements in the fiscal stance and the overall economic performance in the second half of the year. However, this only degenerated into a full-scale political, financial and economic crisis towards the end of the year, leading to a dark and uncertain future. A year, which began with crisis in the government, ended also in vain, only under much worse political circumstances.

Prime Minister Ion Ciubuc's resignation on the 1st of February 1999 unleashed a very deep and protracted crisis. Since his nomination as Prime Minister in February 1997 and, for the second term, in April 1998 (after Parliamentary elections in March 1998) he had been always considered as "the President's man". The Alliance for Democracy and Reforms, a parliamentary coalition formed after 1998 elections which comprised the Democratic Convention (composed mostly of Ex-President Mr. Mircea Snegur's Party of Rebirth and Reconciliation and the Christian Democratic Popular Front), the Block of Democratic and Prosperous Moldova (Pro Presidential Movement headed by Mr. Dumitru Diacov, Chairman of the Parliament) and Party of the Democratic Forces (with Mr. Valeriu Matei as its leader) never considered Mr. Ion Ciubuc as its representative, but rather a "creation" of Mr. P. Lucinschi. Mr. Ion Ciubuc was accepted by the coalition partners in 1998 due to their inability to put forward a serious common candidate and as the only way to avoid confrontation with the President. But, after having been accepted, Ciubuc came under the fire by his critics who attacked him for incompetence, inconsistencies and subservience to the President.

The Russian financial crisis of August 1998 afflicted a very serious blow to the Moldovan financial system and economy, making Mr. Ion Ciubuc even more vulnerable. Finally, the President himself drifted away from supporting Ciubuc, probably realizing that he had to change him in order to consolidate his own position.

Mr. Ciubuc's resignation surprised no one in the political circles, being already long expected. Nor did his letter of resignation that blamed the "algorithm" (i.e., the quantitative formula of the distribution of responsibilities in the cabinet members agreed upon by the Coalition partners) for the poor performance of his Government. At that moment everybody seemed to believe that the President himself inspired this letter.

Without properly consulting parliamentary majority (procedure envisaged by Art. 82.1 of the Constitution of Moldova), on February 5th, 1998 the President named Mr. Serafim Urecheanu, Lord-mayor of Chişinău, the capital, as Prime Minister. Basically, the same selection formula was used as in the case of Mr. Ion Ciubuc in April 1998: allegedly a "technocrat" (and popular at the time), and a non-political and a non-party figure. The major difference was that Mr. Urecheanu was not "The President's man", but rather his potential rival in the 2000 Presidential elections. There was information that Mr. Lucinschi wanted to destroy Urecheanu politically by making him a scapegoat for the country's difficulties. Probably, the President expected that the Coalition would accept Urecheanu as it did a year ago with regard to Mr. Ciubuc.

That was not to happen, though. A categorical refusal by Urecheanu to accept the principle of "algorithm" and his determination to bring with him his own team from the Lord-Mayor's office, as well as a lack of any economic or other program left no room for any agreement with the Coalition. He withdrew his candidature after a short time.

On the 17th of February, the President attended the Coalition meeting and proposed that it selects its own candidate, whom he promised to designate. This produced new convalesces within the Alliance suffering from internal divisions. The biggest problem lies within the Democratic Convention, an uneasy alliance of Mr. Snegur's Right-right Party and the extreme right wing, overtly pro-Romanian, pro-unification Popular Front with Mr. Iurie Roșca as its leader. Formed after the 1996 Presidential elections during which the Popular Front supported Mr. Snegur's bid for re-election, this alliance began to crumble immediately after the 1998 Parliamentary scrutiny. There were many reasons for this, the most evident being perhaps personal rivalries between Roșca, as the co-chair of the Convention, and Mr. N. Andronic, Snegur's deputy in his Party.

It was Roșca who urged Snegur to accept Diacov's demand to be elected the Speaker of the Parliament as a precondition for forming a coalition with Democratic Convention (in exchange, the Democratic Convention was promised Prime-minister's office). That rivalry was also primarily responsible for the President's success in forcing the Coalition to accept Mr. Ciubuc for the Prime minister's office in April 1998. This time Snegur and Andronic decided to press ahead with Andronic's candidature for Prime-ministership, but Roșca once again refused to follow suit. Angry exchanges between the two fractions of the Democratic Convention led to its breakdown, leaving the Popular Front with 9 seats and Snegur with 17 (the Democratic Convention was then reconstituted under Snegur's leadership). Soon later Roșca proposed to nominate as the Coalition's common candidate to Prime-ministership Mr. Ion Sturza, Vice-Prime-Minister and Minister of the Economy and Reforms in Ciubuc's Government, a leading reformer and a representative of the BDMPM. Although Sturza shortly earlier had been harshly criticized by the Front for advocating an allegedly "anti-social" program of austerity.

This unexpected turn of events produced a kind of euphoria in the political circles and hopes for a new era of long-over-due reforms. This euphoria was to be short-lived, however.

Immediately after this proposal was endorsed by the Coalition (even Snegur's Party eventually succumbed, asking for the First-Deputy-Prime-Ministership for Andronic), the Popular Front began to request a high price for their generous offer to the BDPM. Essentially, they demanded: a) an exclusion of Andronic from the cabinet; b) two additional ministerial positions - of the Minister of Finance and of the Minister of State. The first was unacceptable, as it would have led to the breakdown of the Coalition, forcing Snegur's Party to leave it. The second was turned down by Prime Minister-designate because he considered (rightly) that the Popular Front had no good candidates for those very important positions.

After some long, exhaustive but unsuccessful negotiations with the Front the Coalition finally endorsed Sturza's Government by a majority of one vote on the 12th of March. This last, 52nd vote (sometime earlier the Constitutional Court had ruled that the majority of all deputies elected - 101 - was 52 and not 51; when in the first attempt to endorse Mr. Ion Sturza's Government 51 votes were cast in favor, and the Constitutional Court said it was unconstitutional) belonged to Mr. Ilie Ilașcu, a deputy from Matei's Party who is a prisoner of the Transnistrian regime since 1992. Certainly, he was voting "by correspondence" which was smuggled out of the prison. The Constitutional Court, having been seized on the constitutionality of the issue, refused to examine it in substance saying it was "an internal matter of the Parliament". Thus the Government was sworn in on the 13th of March 1999. The circumstances under which this took place bode unfavorably for the future of the Government.

Nevertheless, to the surprise of many observers, the Government was succeeding in many respects. In May the exchange rate showed signs of stabilization, the IMF and the World Bank were resuming financing of the country and from June 1999 the economy started to gradually improve. Most of this was due to the bold efforts of the Government to implement the structural reforms agreed upon together with the IMF and the World Bank and voted upon by the Parliament at the end of the 1998. The main features of the reform program were very austere budget, pensions reform, including raising the pension age, and privatization.

Local elections of May 23, 1999 failed to produce any serious change in the balance of political forces in the country. Essentially, all parties confirmed the results of 1998 Parliamentary elections: the Communists came first without increasing their share of votes (approximately 30%), the BDPM the second, the Democratic Convention the third and the Party of Democratic Forces and the Popular Front shared the fourth and the fifth positions. Neither the leftist stubborn opposition of the Communists, nor the populist campaign of “clean hands” of the Frontists, who accused everybody beside themselves of corruption, produced any tangible results. The electorate seemed to endorse the reformist policies of the Coalition.

Unfortunately, around the same time a new point of tension appeared between the President and the Parliament, especially the ruling Coalition. On the 22nd of March the President issued Decree N 930-II calling a consultative referendum to be held on the 23rd of May, the day of local elections. Voters were asked to answer “yes” or “no” to the following question: “Do you support changing the Constitution in order to introduce the presidential system of governance in the Republic of Moldova, where the President will be responsible for forming and leading the government, as well as for the results of governing the country”.

Soon afterwards practically all political parties declared themselves to be against this proposal, and even the pro-presidential BDPM only reluctantly and vaguely appeared in favor. Nevertheless, because the parties were fighting with each other in the local elections, the President had a free hand in using TV time accorded to him without payment (all parties had to pay for their TV time) to make his own case to the public.

In effect, 58.3% of the electorate as a whole participated in the referendum, 55.3% ballots voting in favor, 30.85% against and 13.8% were declared invalid. Given that according to the Article 168.1 of the Electoral Code, when a draft constitutional law is put to referendum, for its approval a majority of 50% of *all registered voters* plus one vote is required, and that on May 23 only about 32.3% of all registered voters voted in favor, this result could hardly be considered an approval of President’s idea of a constitutional reform.

Nevertheless, on June 5th the Central Electoral Commission validated the results of the consultative referendum (according to Article 171 of the Electoral Code, Central Electoral Commission *could* and did not have to declare a referendum invalid when less than three fifths of the whole electorate participate). On June 15th the Constitutional Court confirmed the decision, thus opening the door for further constitutional experiments.

On the 1st of July the President signed Decree N 1070-II forming a National Commission and instructing it to elaborate, within a month, a draft law on the modification of the Constitution for establishing a presidential system of government. The Decree envisaged that the draft would be sent for opinions to the national and international institutions and that, having received those opinions, the Commission would finalize the draft within a period of 15 days, taking into consideration proposals contained in those opinions as well as those to be presented in public debates. This would then be forwarded to the President in view of establishing a procedure to adopt a law, in accordance with the Constitution and the Electoral Code.

In order to implement this instruction, the National Commission prepared and published in early August a draft law on the modification of the Constitution. This draft effectively subordinated the Government to the President, making him the head of the High Judicial Council and ultimately the “supervisor” of the courts and Prosecutors. The role of the Parliament was to be severely curtailed, effectively bringing it under the control of the Executive Body.

This draft law provoked furious reaction, and even the previously pro-presidential BDPM of Diacov strongly criticized it. So the rupture appeared between this formation and the President, and the conflict between the Presidency and the Legislature, which started with calling of a consultative referendum by the President, intensified.

On the 6th of August this draft was sent for examination to the Venice Commission – an independent body of legal experts working under the Council of Europe (President Lucinschi

promised to collaborate with the Venice Commission while on an official visit to Strasbourg in June). The preliminary draft opinion of the Commission was prepared already in September, and it was unsurprisingly negative. For fear of undesirable publicity, the National Commission started to revise some of its proposals hoping to obtain a favorable opinion of the Venice Commission. However, this was not to be the case.

The Venice Commission was ceased by the Parliamentary Assembly of the Council of Europe on the same issue, and given that its preliminary opinions were strongly negative, the moods of the Assembly began to move strongly against the constitutional reform in Moldova as envisaged by the President. During the Monitoring Committee's reporters visit to Moldova in the early November, this negative assessment was conveyed straightforwardly to President Lucinschi, as well as in the less cutting but clear enough form, to the general public.

In the course of its meeting on November 15th, the Monitoring Committee approved "the information note on the visit of the Reporters to Moldova (2-3 November, 1999)" (AS/Mon (1999) 29). In this document, a reference was made to the work of the Venice Commission on Moldovan constitutional problems which stressed that the draft of the National Commission *"still includes a number of elements which are not compatible with the principle of the separation of powers and which thus do not allow the conclusion to be reached that the draft is compatible with European democratic standards."*

It should be added, in this context, that the National Commission turned down the proposal of the Venice Commission to mediate between it and the Moldovan Parliament claiming that a compromise formula was fined that would permit consolidating the Executive's competencies and political stability within the framework of European democratic standards.

Meanwhile, on November 3rd, the Moldovan Constitutional Court, having examined the Moldovan Constitution in part referring to the proper procedure to follow in case of constitutional revision (on the request of the two deputies from the governing Coalition), ruled that it is only the Parliament, which has the right to change the Constitution. This could be done in two ways, either by voting in favor by a two-thirds majority after the presentation of a draft upon the expiration of 6-month period together with the Opinion of the Constitutional Court, or by calling a constitutional referendum following the same procedure.

This historical decision of the Constitutional Court severely curtailed the possibility for President Lucinschi to implement any constitutional reform as envisaged by him. Nevertheless he made it clear that he would press ahead with this idea and "ask" the Parliament to call such a referendum. To this end he organized a campaign of collecting signatures all over the country under the petition to be presented to the Parliament requesting to hold such a referendum – even before the draft was published and the opinion of the Constitutional Court obtained! A new party "Republica" is being organized to support this action.

Since Lucinschi realized that he had become politically isolated, he decided to change allies and try to fragment and discredit his political opponents. His main tool in this respect was General Alexei, head of the Department for Fighting Corruption and Organized Crime within the Ministry of the Interior. This Department was set up by Lucinschi immediately after having been elected the President. Initially it was established under the President himself, but the Constitutional Court ruled it as unconstitutional. Following this decision the Department functioned within the Ministry of the Interior.

On balance, General Alexei proved to be very inefficient in fighting corruption and organized crime, but quite effective in discrediting the President's opponents. Almost all the files prepared and brought by him to the Prosecutor's Office and to the Courts failed, but he never ceased to publicly denounce Lucinschi's opponents of being linked to the Mafia. Though unable to produce any sound evidence and constantly losing in the courts on charges of defamation, he managed to seriously damage the reputation of Valeriu Matei, the leader of the Party of Democratic Forces, who was finally dismissed from his position as a deputy speaker of the

Parliament. It goes without saying that both the Popular Front and the Communists were applauding Alexei's actions.

Since the General presented a serious threat to normal functioning of public institutions and to ruling Coalition, in the early September the Ministry of the Interior's Board finally dismissed him from his position on the grounds of abuse of power and fraud (many cases of this kind were demonstrated).

The President took the side of General Alexei accusing the Ministry of obstructing the fight against corruption. This made the whole situation even more tense. Since then the President began to use Russian mass-media (TV and papers published in Russia which are still popular and influential in Moldova, but which are known to be corrupt and unscrupulous) to discredit his political opponents accusing them of links to the Mafia.

Until the end of its summer session, however, the Parliament, though with some difficulties, supported Sturza Government's measures, which allowed the country to move forward on the road of reforms and thereby to regularly receive external financing on better-than-market terms. Since September it was getting clearer that the Coalition was losing a majority necessary to support the Government. The most urgent measures needed to be approved by the Parliament were those of privatizing the wine factories, tobacco industry, amending the 1999 budget, and approving the 2000 budget. The Communists, the Frontists and the President were blocking those measures thus forcing the Government to resign.

On the 4th of November Prime-Minister Sturza presented in Parliament his program of policy measures necessary to overcome the crisis and ensure economic development of the country. He presented the achievements of his Government, outlined future developments and options and underlined the risks connected with letting the Government down at that particular stage. At the end of his speech he added: "I will not participate in the coup d'état".

Immediately after this sitting the Communists and the Frontists began to collect signatures for the motion of censure. On the next day, November 5th, 1999, President Lucinschi summoned the Communists to his office and urged them to go forward with this motion. It was presented the same day. During the press conference held on the 8th of November, on the eve of the voting of the motion of censure, President Lucinschi said he would have voted against the Government had he been a deputy, citing as a reason "neglect of the real sector" (an allusion to the fact that the Government stopped interfering with day-to-day activity of the state-owned enterprises).

On the 9th of November, upon the expiration of a 3-day period following the presentation of a motion of censure required by the Constitution, Ion Sturza's Government was dismissed by a vote of 58 deputies out of 101. Voting in favor of the motion of censure were the Communists, the Frontists and the so-called "independents" who defected from the parties of the Coalition.

Immediately afterwards, a new majority was announced – that of the Communists, the Frontists and independents. It is hard to see how this impossible coalition of extreme right and extreme left could work together, given complete incompatibility of their programmes and ideologies. Nevertheless, the President was optimistic about forming a new government "within a week". On the 11th of November the President designated Mr. Valeriu Bobuțac, the Moldovan Ambassador to Moscow, as Prime Minister, instructing him to form a government.

Bobuțac was a Minister of Trade in Druc's and in Muravschi's Governments (1990 – 1992), as well as Minister of the Economy in Sangheli's Government (1994-1996). He could hardly be seen as a convinced reformer and a "new blood".

On the 22nd of November Bobuțac's Government and its programme were put to vote in the Parliament, but failed to collect the necessary number of votes (48 out of 101 deputies voted in favor). This result was due to the Popular Front's last minute defection from supporting this

government, once more citing “suspicions” that some of the Ministers proposed “might be” corrupt.

On the 2nd of December Mr. P. Lucinschi designated Mr. V. Voronin, First Secretary of the Party of Communists as Prime-minister candidate. But he also failed to succeed, receiving only 48 votes on December 7.

At the moment this text is being written it is not at all clear whether the new government will be formed or the country is heading for an early parliamentary elections during winter, and under extremely unfavorable circumstances. But what can be ascertained without doubt is that the immediate future is bleak. The IMF and the World Bank have already announced the suspension of their disbursements to Moldova, investors are fleeing the country (e.g., those who only recently announced their interest in buying Moldovan electricity distributors), confidence is diminishing and prices soaring. External financing is crucial for the survival of the country, but the IMF and the World Bank made it clear that they would not resume it until the new government established its own “track record” which will have to be long enough. The budget for the next year will have to be revised in order to make it more commensurate with diminishing resources.

Ion Sturza’s Government was probably the only government since Moldova’s independence that sincerely and vigorously promoted genuine market reforms and implemented a pro-European strategy. To the surprise of many, it achieved some positive and concrete results.

Among other it demonstrates that genuine market reforms could bring in Moldova concrete improvement in standards of living of both urban and rural population in a relatively short period of time. At the same time it created, one may hope, some powerful momentum for democratic and reformist forces in the near future.

13. ECONOMIC CRISIS OR CRISIS OF GOVERNANCE?

The crisis of governance comes from a continues lack of capacity within the state structures, which were formed on the basis of constitutional norms in order to meet the citizen's expectations and to restore their lost confidence in a participatory procedure for problem solving through elections.

The year 1989 can be considered as a starting year of the irreversible changes in the society, which transformed the Soviet Socialist Republic of Moldova (SSRM) into an independent state. Ten years on, the contrasts between the expectations and the reality is becoming increasingly obvious. Economic crisis is most frequently mentioned. Meanwhile, holding frequent periodic elections, parliamentary and presidential, has not produced much positive results in between. The words "The road to hell is paved with good intentions" perfectly describe the cycles of the political life in Moldova. Since 1994 the society has gone through non-stop elections characterized by violent political confrontations. Change of Governments takes place more and more frequently. Under such circumstances, the government crisis in itself becomes an issue. A 10-year period is sufficient for running an analysis of the political, economic and social processes, with a reduced risk of confusing the short-term changes with general tendencies.

Let's start from the very beginning.

The first experience of democracy

The Soviet Union even after 70 years of existence did not constitute a homogeneous entity. One could presume that the fifteen former union republics could be ranked in a descending "chain" regarding their degree of readiness to become independent states and the ability to self-govern through mechanisms of jural state. The Soviet Socialist Republic of Moldova could be ranked somewhere in the middle of the chain.

The Baltic States were the first to give birth to popular fronts, which consciously placed themselves in opposition to both the republican level bodies of CPSU and the Communist ideology as a whole, and started to exploit each moment of Moscow's central power weakness to enhance their degree of independence. The new political forces in the Baltic States were the first that acknowledged the importance of the economic aspect for political independence and launched the idea of economic self-financing. The intellectual potential of the society, having overcome the level of linguistic problems, focused on the whole set of problems related to statehood restoration, under the extremely hard conditions of Soviet Union disintegration. Notably, the Baltic States avoided most of the problems that Moldova is facing today. In the period of provocations and separatism supported from abroad, this threat was avoided. The economic reforms were fruitful not only for corrupt office holders, but also for society as a whole. The Baltic States are regarded as real candidates for full membership of the EU and NATO.

Although the SSRM reached the composition of Soviet Union on a scenario similar to that of the Baltic States, the attitude towards the USSR, communist ideology, historical background, and the vision on the future, amongst the population was totally different. In Moldovan society the post-1985 political processes ran mostly by way of mechanical imitation of those from the Baltic States. First of all, in Moldova there is no massive and conscious support of the state independence idea. The population was very heterogeneous with regard to their attitude towards

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historical background relating to Basarabia's in Romania the Molotov-Ribbentrop pact, etc. In the industrial centers on the left bank of the River Nistru the attitude towards the perspective of Moldova's transformation into an independent state was even aggressive. The main new political force, the Popular Front of Moldova, from the very beginning did not show the necessary qualities to become a driving force of the SSRM's transformation into an independent state and consciously, did not target such an objective. It was characterized by a simplistic approach to problems pertaining to "national renaissance", which in its turn was reduced only to linguistic aspects. In the summer of 1989 the republican organization of CPSU lost any initiative and was in an obvious deadlock. The Popular Front proved to be incapable to definitely take over the political initiative and at one of the rallies, the appeal was launched to Michael Gorbachov that in lieu of a "bad communist", the first-secretary Semion Grossu, to assign Petru Lucinschi as a "good communist". Later, a particularly ill-fated role for the political evolutions in Moldova was the populist approach on behalf of the Popular Front partisans, with the idea of political unification of Moldova with Romania. This indeed contributed only to enhancing the separatism manifestations in the Southern and Eastern parts of Moldova, to worsening the social splitting-up based on ethnical criteria and prepared the grounds for subsequent political revenge of the political forces and individuals from the Communist Party (1992-1998). The leaders of the Popular Front, unable to acknowledge the importance of the economic aspect, did not involve economists in this political formation's activity. The participation of the economists could have offered some practical solutions to the complex problems of moving to a market economy, while consolidating the economic foundations of the new state.

The first democratic elections of deputies during February-March 1990 to the Supreme Soviet (later Parliament) of the SSRM and the events that followed afterwards proved that the Moldovan society was just starting to assimilate, "on the move", some elementary notions of democracy. The initial 380 mandates at the Supreme Soviet were distributed as follows - only one third of them were attained by the Popular Front. The other two thirds of Parliament mandates were attained by agricultural enterprise managers (kolkhozes and sovkhozes) and "Russian-speaking" deputies, elected basically in the industrial centers of Moldova. 64 deputies represented the circumscriptions from Bender and from the left bank of the river Nistru.

Only at the first phase of this legal body's activity there was a clear majority of about two thirds formed, albeit on ethnical grounds. As long as the "sovereignization" euphoria lasted there were there were votes in favor of the Declaration on sovereignty, dated 23 June 1990, the symbol of the new state and the first government headed by Mircea Druc. However, just after this "emotional-national" phase was over, the Parliament entered a continuous process of splitting-ups and regroupings. This process was conditioned by the corporate interests of some deputies, their different attitude towards the USSR dismantling process, involvement of some more deputies in setting up new parties, etc. Despite that, the mandate of the Parliament expired in 1995, noting that by the fall of 1993 it had already split into 8 deputy "clubs". With almost half of them did not participate in sessions, the legislature of the country that was vested by people's expectations became totally paralyzed. Only under the impact of the political events in Moscow, from October 1993 (i.e. the forced dissolution of the Supreme Soviet by Boris Yeltsin), were the deputies able to vote in the Law on elections to the Parliament and fix the date of anticipated elections on 27 February 1994.

It is necessary to mention, that the change of forces' correlation in that Parliament during the mandate commenced a "tradition" of Governments' sacrificing. The first Government headed by Mircea Druc "fell" as early as in 1991. His successor, Valeriu Muravski left in 1992 after a political crisis provoked by the tragic dénouement of the armed conflict in Transnistria. Under the pressure of the deputy club "Viața Satului" (Rural Life), the President of Moldova Mircea Snegur proposed Andrei Sangheli to the office of prime-minister, a person who in no

way complied with the “revolutionary” slogans of 1988-89. At the same time, Andrei Sangheli’s assignment as prime-minister symbolized a loss of all the positions held by the Popular Front and the return of the Communist Party under “agrarians” trade mark.

The first government and the first programme of economic reform

“The hard way of transition to market economy is assumed to be through in a shortest period of time, of approximately 1.5-2 years” – this was a citation from the “Transition programme to market economy in the SSR of Moldova”, approved in 1990 by the Supreme Soviet of Moldova. The transition to market economy was supposed to be followed at four stages, the last one envisioned to include the “conclusion of stabilization period”. Today, with hindsight, it is obvious that the programme was unrealizable. First of all it contained a fundamental political-economic ambiguity – the intention was announced of implementing radical economic reforms on a territory which constituted a small part of a unified, single state – ex-USSR. At the same time, at the Supreme Soviet a conscious and firm support of the economic reforms, as well and of the “sovereignization” of Moldova were missing. The first attempts to go from words to actions proved that they were first of all contradictory to the corporate interests of the “agrarian” deputies. After breaking-up the “national” majority they constituted the deputy club “Viața Satului”. Afterwards, the banning the activity of the Communist Party in August 1991 lead to the idea of setting up, in October 1991, the Democratic Agrarian Party of Moldova, as a political instrument for protecting its corporate interests.

In its turn, the Government headed by Mircea Druc, representative of the Popular Front at the time, admitted a series of hard political mistakes, which produced further tensions in the Southern and Eastern parts of the Republic of Moldova. Separatist manifestations went totally beyond the control of the central power in Chișinău and gave one more reason for destabilization of the political situation in the country and for missing the fragile chances to consolidate the society with a view to settle the economic problems. Thus, the Government too lost the chances to promote economic reforms. Which could have offered unique experiences in gaining competence.

Consequently, the first Programme of national economic reforms remained merely a declaration of intention.

Institution of parliamentarism and multi-party system in Moldova – 1989-1999

In conformity with the Constitution of the Republic of Moldova, adopted in 1994, the Parliament is vested with enormous authorities (Article 66). Starting from 1994 the parliament elections ran based on proportional party lists. Thus the political parties have an extremely important role in the political life of Moldova, and their “quality” decisively affects the direction and trend of the processes running in the society. Starting from 1989 Moldova has been going through a difficult but natural process of building-up the political spectrum. During these years the constitution of more than 50 parties has been announced. In most cases they did not have as basis of their activities any clear doctrines. Splitting-ups, personal ambitions, their ranks completion based on personal fidelity towards their “leader” became soon became a tradition for this process. The experience of 1990-98 elections shows that so far the political spectrum is dominated by a group of secluded individuals, who after having changed many other parties during those years almost monopolize the right to be present in the parliament. The electoral campaigns are financed by cash, the poll of 1998 practically put into practice the merchandising of the places on the candidates’ lists. Thus, the electoral campaign becomes a phase of an unavoidable corruption of power. The behavior of the elected MPs on the lists of those parties is

often unpredictable as compared to electoral campaigns. Under the conditions of an eventual conflict of interests, the position of deputies becomes a subject of bargaining, while factional splits, particularly of the governing majority, has become a chronic ailment. The electoral message usually is reduced to populist promises. This particularly refers to the extremes of the political spectrum; Popular Front and Communist Party. For instance, until 1996 the Status of the Popular Front comprised the following stipulations:

- The fundamental purpose of the Christian-Democratic Popular Front Movement is to contribute to the liberation of occupied Romanian territories and to the reintegration of Romania as an Unified National State.

Significantly, both the idea of unification with Romania and that of constructing Communism after elections were declared by the leaders of respective political formations as “dreams”. In reality they constitute some electoral baits for the respective segments of electors.

In the activity of the parliaments elected in 1990, 1994 and 1998 some common traits can be traced. None of them have had a stable correlation of forces during the mandate period. As mentioned above, in the Parliament elected in 1990, after the “national-emotional” phase was over, the majority disappeared, which might be charged for a political responsibility. In the following Parliament, elected in 1994, the Agrarian Democratic Party (ADPM) had an obvious majority (56 mandates of 104 places). Yet, it did not necessarily mean a stable governance over the four years of its electorate platform. The explanation is simple – before elections this party already had the image of “the party in power”. Consequently the ADPM’s candidates list comprised people whose common purpose was not their “agrarianism”, but rather their desire to become deputies. ADPM was set as the “carrier” to the Parliament. Thus, once their seats were replaced, their unique consolidating factor vanished. Since 1996, the Presidential elections started to play a decisive role in destroying the Parliament majority and ADPM as a whole. Mircea Snegur, Petru Lucinschi, and Andrei Sangheli, having profited by their positions, and Vladimir Voronin – by the Communist nostalgia among the “Agrarians”, tore up the parliamentary faction of that party.

Just after the Presidential elections on December 1, 1996 the Government headed by Andrei Sangheli retired and the same parliament voted in favor of forming the Government headed by Ion Ciubuc (Ciubuc-1). Replacing the prime-minister and modifications in the Government composition did not mean a new way of reform promotion, - the Parliament, elected in 1994 lost its quality of representative of the Moldovan citizens’ interests and of political supporter to activities targeted towards reaching electoral promises. The newly elected President of Moldova – Petru Lucinschi, took over the political initiative. Yet, notably, neither Mircea Snegur in 1991, nor Petru Lucinschi in 1996, were backed by consolidated and competent teams. These might have been capable to take over the executive power of the “steering-wheel”, based on their electoral platforms and political capital as the freely elected head of state. Thus, the quality of the elected Parliament in 1994 did not provide for its survival in the political battles of 1996. Moldova was left with a paralyzed Parliament and although the Government changed, it did not entail any positive changes for the society.

Nevertheless, the method of deputies’ election to the Parliament on party based lists engendered the first effect to the following elections of 23rd March 1998 when the Moldovan electorate cruelly punished the *name* of Agrarian Democratic Party (a good number of those on the “Agrarians” list in 1994, had become deputies to the “new” parties in 1998). ADPM did not even pass the threshold of 4% (gaining only 3.6%) and thus disappeared from the political arena altogether. In Moldova a precedent was created, when politicians for the first time perceived the notion of *political responsibility*.

The Parliament formed after the elections of 23rd March 1998, were essentially distinguished from previous one in terms of balance of forces. First of all, no electoral competitor succeeded to attain an absolute majority in the Parliament. The Communist Party holding 30% of votes ranked first and won 40 seats, which was insufficient to form a “mono-color” government. The “right-wing” political formations did not receive the necessary number of seats for governing either. After the negotiations the formation was declared of the Alliance for Democracy and Reforms (ADR) based on joint “anti-communism” forces of the component parts and formed the coalition Government headed again by Ion Ciubuc (Ciubuc-2). A particular role in forming the coalition was played by the “Centrists” – the Block for a Democratic and Prosperous Moldova (BDPM) headed by Dumitru Diacov (24 seats). This block was formed by consolidating a political formation, which in 1996 acted in favor of electoral success of Petru Lucinschi, comprised of rather amorphous political formations. The sole electoral slogan of BDPM was as follows: “We are Lucinschi’s team! “Notably, Ion Ciubuc’s candidacy for the position of Prime minister at that time was convenient to both the President and BDPM.

The situation changed in February 1999, when Ion Ciubuc retired after failing to run the coalition government, while Petru Lucinschi did not manage to promote another candidate. After the first unsuccessful attempt of the President to assign Serafim Urecheanu as the sole candidate with real chances, Ion Sturza emerged (in Ciubuc-2 cabinet he was Vice-prime Minister, Minister of Economy and Reforms). Thus, the Parliament majority (ADR) took over the political initiative in the country. Formation of the cabinet headed by Ion Sturza was complicated due to the withdrawal of CDPF (with nine seats) from the ADR. This step by the CDPF, regardless of the invoked reasons, reduced Ion Sturza cabinet’s support to the minimum, and hence created the premises for the subsequent political destabilization in Moldova.

Destabilization also followed within a short while after Petru Lucinschi launched the idea to modify the Constitution and transform Moldova into a presidential republic. As such, the president started *de facto* a struggle for the second mandate of presidency. However, no political formation in the Parliament, including the BDPM, supported this initiative. At the same time, Ion Sturza’s Government step by step advanced in de-blocking the financial crisis and instituting the elementary order in public funds management, energy sector, etc. Pension and salary arrears started to shrink; the Government submitted the concept of 2000 budget, which stipulated a modest increase of salaries for the budget sphere employees. Running an independent policy, as compared to that of the President of the country, created some positive expectations of Ion Sturza’s cabinet, which proved to be troublesome for the President’s perspectives of the elections in 2000. Given the political conflict, the political erosion of ADR sharpened, starting with BDPM.

A new group of “independent” deputies emerged, followed by the motion of censure on 8 November 1999, based on which the Ion Sturza’s cabinet was dismissed by 58 votes, after less than 7 months of activity. The votes for the cabinet dismissal came from the representatives of the Communist Party of Moldova (40 votes), CDPM (9), and the “Independents” (9).

Subsequently, in the current parliament the majority of deputies served only half of their terms of office. The conflict of interests, which categorically contradicts the interests of the population, brought political stability to an end, together with the chances to overcome the economic crisis. After ten years of “democracy” and “reforms” on December 1, 1999 Petru Lucinschi, through Presidential Decree, assigned Vladimir Voronin, the first secretary of the Central Committee of the Communists’ Party of Moldova (CPM), as candidate for the position of Prime minister. The status of the Communists’ Party of Moldova, *inter alia*, contains the following stipulations:

- It is the successor of the ideas and traditions of the Communist Party of Moldova, which ran its activity until 1991;
- It stands for creating, based on new principles, of the brotherly Union of the CIS nations and for international solidarity with Communist Parties in other countries;
- In developing the policy and principles of practical activities of the CPM, it is guided by Leninist-Marxist theory, taking into account its evaluation and completion with current achievements of contemporary science and experience of international communist and workers' movements.

The president asked the new candidate to ensure a continuation of the reform process for integration into Europe. In other words, the Communist Prime minister is supposed to realize the programme of the former Cabinet, severely criticized and dismissed by the Communist deputies.

Nowadays there is no guarantee that Vladimir Voronin will manage to have needed support in the Parliament to be able form a new Cabinet. In any case even if the preliminary elections are not carried out in the spring of 2000, the political stability, and with it, any other chances to surpass the economic crisis in Moldova, are sacrificed for the sake of power struggle.

The Transnistrian conflict

Armed confrontations in the Eastern rayons of the Republic of Moldova ceased in July 1992. Nonetheless, this problem remains at the edge of the public attention. The Transnistrian conflict requires due attention, given its extremely negative impact on Moldova in the past ten years. The conflict was unleashed due to ideological reasons, an outcome of many factors, in the main provoked by the USSR disintegration, lack of political elite in Moldova which might be capable to consolidate the society and annihilate the separatism manifestations, separatism support from abroad and the presence and direct involvement of the 14th Army troops.

Negotiations with regard to the legal status of the localities from the left bank have been going on for many years, yet they are in an obvious deadlock as the perspective of addressing the conflict remains unclear. Instead, the undefined legal status of this zone, missing economic borders with Chişinău alongside the river Nistru, immediately started to be exploited for tax evasion, smuggling, etc. It is obvious that passivity and inconsistency of Chişinău officials concerning Transnistrian separatism can be explained, in line with domestic political confrontations, only by the existence of an influent *lobby* of Tiraspol comprising corrupt individuals of the state structures. During the negotiations process Tiraspol attained from the Moldovan authorities a series of unilateral concessions in the economic field. As far back as on 7 February 1996 the administration from Tiraspol obtained from Moldova the customs seal with the inscription: "Republic of Moldova. Tiraspol Customs". The economic agents from Transnistria, regardless of the fact that they make no contribution to the Moldovan budget, benefit from all possibilities for running economic activities abroad, offered by the Moldovan state. The state structures of the Republic of Moldova generously offer all the necessary provisions for that. At the same time, the most unpretentious calculations show that in 1998 alone, the volume of smuggled goods subject to excise duties in Moldova through Transnistria amounted to over US\$ 500 million. The losses incurred by the state budget entailed by tax evasion and flows of contraband with Transnistrian involvement are comparable to the aggregate technical assistance received by the state of Moldova from International Financial Organizations. The economic crime rates, with the involvement of the Transnistrian zone, are a real threat for the statehood of Moldova and provoke a massive corruption of the state structures. One could remark that the Transnistrian conflict does not exist any longer in reality,

but both “the Dniestr Moldavian republic”, and the negotiations process are a political coverage of the mechanism of enriching a certain circle of individuals on the both banks of the river Nistru through economic crimes.

The Demos

There are a lot of definitions of the notion of *democracy*. Anyway, this means formation of due structures of a jural state, through regulated citizens’ participation, free and fair elections. From a formal viewpoint, the Moldovan state possesses all requisites of democracy necessary for society’s self-government, deriving from the interests of the citizens’ majority. At the same time, the continuous aggravation is obvious of social-economic position, crime breakout, corruption, etc. According to some estimates, about 300 thousand Moldovans left for abroad in search of means for survival. The natural question emerges - why?

The irreversible changes that emerged after 1989 meant the destruction of the whole social structure of all the “rules of game” from the Soviet system. During the first wave of changes the most active part of the population sincerely supported the slogans: “democracy”, “market economy”, “sovereignty”. However, those notions were compromised by the first promotion of “democrats”. Most of the population did not attain any positive results. At the same time, it turned out that many citizens, either psychologically, or professionally, are not ready to comply with new conditions. This was particularly perceived in rural areas. According to the 1989 census, 53% of the population lived in the countryside, running their activities within “kolkhozes” and “sovkhozes”. During the electoral poll of 27 February 1994, over 820 thousand voters voted for the Agrarian Democratic Party of Moldova just due to the fact that the electoral message of that party responded to voters’ nostalgic expectations. Another nostalgic political force, for the “Russian-speaking” population - the Internationalist Movement “Unitatea-Edinstvo” - obtained 28 seats. The Patriotic Democrats gained only 20 out of 104 seats.

The conclusion is the one already derived long ago, - the “quality” of the political elite of any society is in close correlation with the “quality” of the society itself as such. The formal application of democratic mechanisms *per se* does not guarantee the progress of the society. The sociologists operate with such notions as *political culture*, *civic culture*, etc. The behavior of Moldovan society perfectly matches the inferior, *parish*, level of political culture. State citizens’ inability to consolidate for the purpose of protecting their personal interests, including through protest manifestations, is the most convincing symptom in this regard. The apathy and lack of citizens’ confidence in the mechanisms of democracy and jural state has now reached dangerous proportions. The “feed-back” mechanism between the *citizen* and *power* is deregulated and runs erroneously. In the past ten years the Moldovan society has not managed to form, through elections, a continuous political coverage of social reformations. The prevailing economic and governance crisis, immorality, corruption and inability in power structures are only a consequence of this state of affairs.

There are no rapid and simple solutions. This is obvious from the comparative growth of the qualitative level of Parliaments in 1990, 1994 and 1998. But both the competence level, as well as particularly the level of responsibility before the society are much below the requirements imposed by the aggravation of the situation.

Only the anticipated parliamentary elections may offer a chance, but without any guarantees. In case the electors correctly appreciate the current “political actors”, Moldova might obtain a more responsible and consolidated majority in the Parliament and a more efficient Government. Otherwise they will take one more step towards total collapse.

Vladimir Voronin's failure to form a new Government, on 7 December, complicated the situation even more. The balance of forces established in the Parliament does not allow to either form a Government headed by a Prime minister who might represent a parliamentary faction, or a Prime minister as a person entrusted by the President. According to Article 85 of the Constitution, the President obtained the formal right to dissolve the Parliament after 45 days from the first attempt (November 22). Nevertheless, on 10 December it was supposed to name a third candidate – Ion Casian, ex-Minister of Telecommunications in the Governments 1992-1998. But at the last moment, Ion Casian laid down conditions to deputies in the form of guaranteed support for the Government composition as determined by him personally, and the non-involvement of the Parliamentary parties in the procedure of forming the Government, etc. So far the reaction of the parties to these conditions is not known. At the same time, it is not clear to what extent Petru Lucinschi will succeed in promoting his candidates in the composition of the new Government. The next candidate to Prime minister's position was announced on 16 December – Dumitru Braghiș.

Thus, the Republic of Moldova has shown in '90s a tight and not always positive link between the political and economic components of the transition...

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